An Analysis of the President's Budgetary Proposals for Fiscal Year 1985

FEBRUARY 1984

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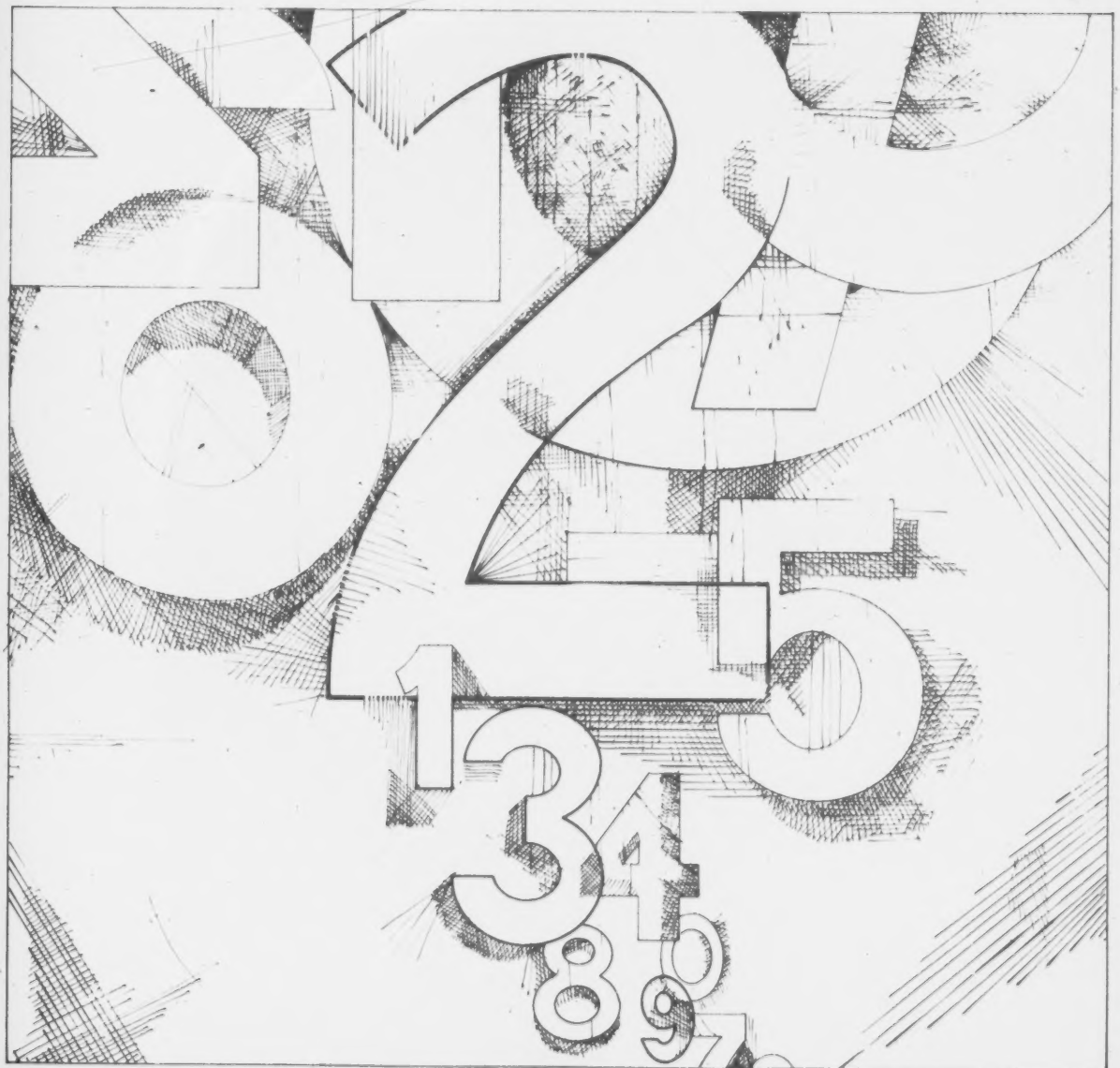

CONGRESS OF THE UNITED STATES

CONGRESSIONAL BUDGET OFFICE

J932-5

AN ANALYSIS OF

THE PRESIDENT'S BUDGETARY PROPOSALS

FOR FISCAL YEAR 1985

The United States Congress
Congressional Budget Office

J932-5

NOTES

Unless otherwise noted, all years referred to in this report are fiscal years.

Details in the text, tables, and figures of this report may not add to the totals because of rounding.

PREFACE

This analysis of the President's budget for fiscal year 1985 was prepared at the request of the Senate Committee on Appropriations. The report discusses the President's policy proposals in terms of changes from the Congressional Budget Office (CBO) baseline budget projections for 1985-1989. It includes estimates of the budgetary impact of the Administration's proposals using CBO's economic assumptions and technical estimating methods.

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Rudolph G. Penner
Director

February 1984

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CHAPTER I. SUMMARY AND INTRODUCTION

The Congressional Budget Office (CBO) estimates that the budget deficit under Administration policies would grow from $186 billion in 1984 to $192 billion in 1985 and $248 billion by 1989 (see Figure I-1). These estimates are higher than those of the Administration primarily because CBO assumes no decline in inflation-adjusted (real) interest rates. Administration spokesman have stated that the drop in interest rates assumed in the budget is not likely to be achieved without the enactment of deficit reductions above and beyond those the Administration has proposed. Chapter II discusses the economic assumptions of both the Administration and CBO.

CBO projects that, under current spending and taxing policies, the federal budget deficit would grow from $189 billion in 1984 to $197 billion in 1985 and $308 billion by 1989. As a percent of gross national product (GNP), the baseline deficit would decline from 5.3 percent in 1984 to 5.0 percent in

Figure I-1.

Federal Budget Deficit

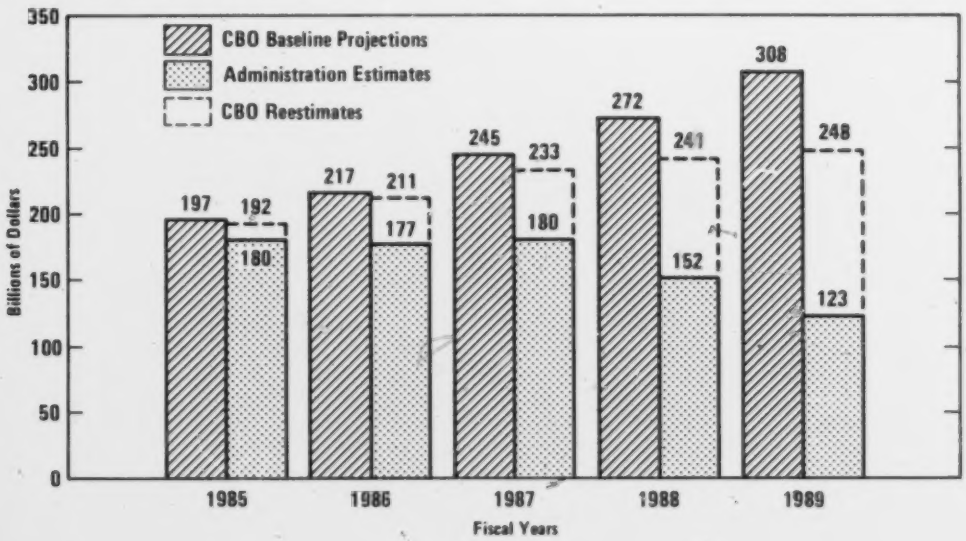


TABLE I-1. THE BUDGET OUTLOOK (By fiscal year)

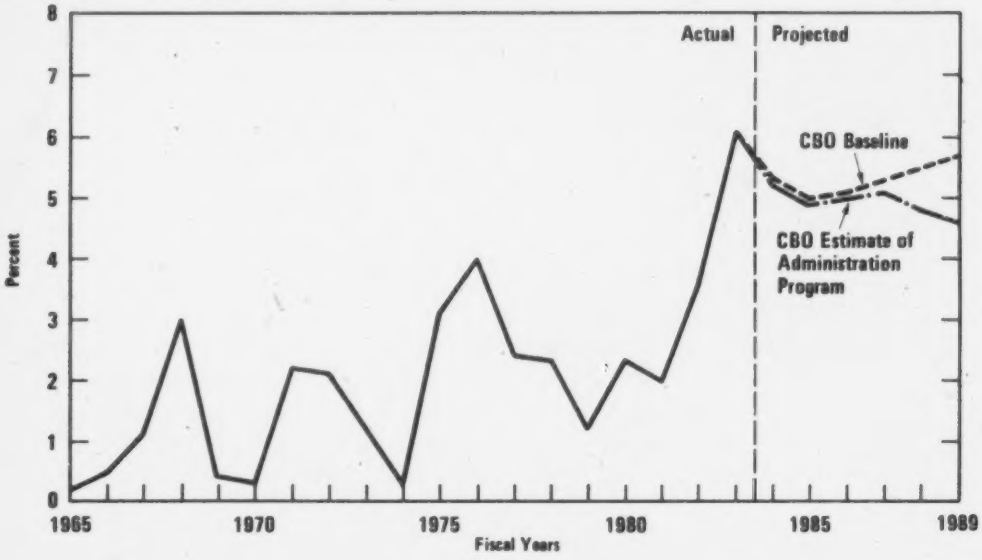
	1984	1985	1986	1987	1988	1989
In Billions of Dollars						
CBO Baseline a/						
Revenues	663	733	795	863	945	1,016
Outlays	852	930	1,012	1,109	1,217	1,323
Deficit	189	197	217	245	272	308
Administration's Program as Estimated by CBO						
Revenues	665	741	807	878	964	1,039
Outlays	851	933	1,018	1,111	1,204	1,287
Deficit	186	192	211	233	241	248
As a Percent of GNP						
CBO Baseline a/						
Revenues	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	23.9	23.8	23.8	24.0	24.4	24.6
Deficit	5.3	5.0	5.1	5.3	5.5	5.7
Administration's Program as Estimated by CBO						
Revenues	18.7	19.0	19.0	19.0	19.3	19.3
Outlays	23.9	23.9	24.0	24.1	24.1	23.9
Deficit	5.2	4.9	5.0	5.1	4.8	4.6
Memorandum: Gross National Product (In billions of dollars)	3,563	3,910	4,251	4,612	4,987	5,379

SOURCE: Congressional Budget Office.

a. The CBO baseline figures are preliminary revisions of those appearing in Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1985-1989 (February 1984).

Figure I-2.

Federal Deficit as a Percentage of GNP



1985 but rise thereafter, reaching 5.7 percent by 1989. The Administration's budgetary policies would hold the deficit-GNP ratio at about 5 percent of GNP in the 1985-1987 period and reduce it to 4.6 percent of GNP by 1989 (see Table I-1 and Figure I-2).

CBO BASELINE BUDGET PROJECTIONS

CBO's baseline budget projections, which are preliminary revisions of those published earlier this month, assume no changes in current laws governing taxes or entitlement spending. For nondefense spending that is discretionary and subject to annual appropriation, the CBO baseline projections generally assume that the 1984 appropriations level will be maintained, with future increases to keep pace with inflation. The projections for defense spending are calculated on a different basis than nondefense programs. The baseline projections for defense not only allow for increases to keep pace with inflation but also provide for roughly 5 percent annual real increases in defense budget authority, as assumed in the Congressional budget resolution adopted in June 1983.

The revisions to the CBO baseline involve only spending and affect primarily the last three years of the projections. The current baseline deficit estimates of $245 billion in 1987, $272 billion in 1988, and $308 billion in 1989 are $3 billion, $10 billion, and $18 billion lower, respectively, than the figures published in CBO's baseline budget projections report. 1/The changes reflect additional technical information gleaned from the Administration budget, which was not available when the previous projections were prepared, as well as a reduction in the estimated rate of inflation in the defense sector of the economy. The revision in the defense inflators, along with its effect on debt-service costs, accounts for the bulk of the changes--$2 billion in 1987, $5 billion in 1988, and $12 billion in 1989.

THE ADMINISTRATION'S BUDGET PROGRAM

The Administration's 1985 budget reflects the same priorities as its 1984 budget request, although the size of the proposed policy changes has been scaled back. Substantially smaller tax increases are requested than last year, primarily because the Administration is no longer proposing a contingent tax increase in 1986 and thereafter. The Administration's defense program is somewhat smaller than that proposed a year ago, although the requested funding levels are still much greater than approved in the latest Congressional budget resolution, which CBO uses as its defense baseline. No new proposals are made for the Social Security and railroad retirement programs, which were subject to major changes last year. Finally, the Administration is no longer requesting or has reduced in size a number of cuts in entitlements and nondefense discretionary spending that it has sought unsuccessfully in the past.

The major elements of the Administration's budget program are listed in Table I-2. CBO estimates that, over the next five years, the Administration's program would reduce the cumulative deficit by $115 billion. Most of this reduction occurs in 1988 and 1989 under CBO's projections. For the next three years, which will be the period covered by the next Congressional budget resolution, the Administration's proposals would reduce projected deficits by only $24 billion compared with the CBO baseline. Also noteworthy is the extent to which the Administration's deficit-reduction measures focus on health expenditures. About $60 billion of the cumulative five-year savings would be achieved through the taxation of certain private health insurance premiums, increased premium charges for Supplementary Medical Insurance, and reduced spending for Medicare and Medicaid.

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1. Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1985-1989 (February 1984).

TABLE I-2. THE ADMINISTRATION'S DEFICIT-REDUCTION PROGRAM AS ESTIMATED BY CBO
(By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Total
CBO Baseline Deficit	197	217	245	272	308	1,239
Proposed Changes						
Revenues a/						
Taxation of health insurance premiums	-4	-6	-8	-10	-12	-40
Other tax increases	-6	-10	-12	-14	-17	-59
Tax reductions	2	4	5	5	5	22
Subtotal	-8	-12	-15	-18	-24	-77
Outlays						
National defense	10	21	23	20	11	85
Entitlements and other mandatory spending	-4	-6	-9	-12	-15	-46
Nondefense discretionary spending	-2	-5	-7	-12	-17	-44
Offsetting receipts	*	-1	-2	-4	-6	-13
Net interest	-1	-2	-3	-5	-10	-20
Subtotal	3	7	2	-13	-36	-38
Total Policy Changes	-5	-5	-13	-32	-60	-115
President's Budget as Estimated by CBO	192	211	233	241	248	1,124

SOURCE: Congressional Budget Office.

a. Revenue increases are shown with minus signs because they reduce the deficit; revenue decreases, which are displayed with no sign, increase the deficit.

Tax changes proposed by the Administration would increase revenues by $77 billion over the 1985-1989 period. The Administration's revenue proposals contain both tax increases and tax deductions. The largest revenue-raising item--a proposal to impose income and Social Security taxes on employer-paid health insurance premiums in excess of certain thresholds--is a repeat from last year's budget. Further tax increase proposals include restrictions on tax-exempt leasing and industrial development bonds, curtailment of certain tax shelters, higher federal employee contributions for civil service retirement, and establishment of a petroleum overcharge restitution fund. New to the Administration budget is a women's initiative, which would expand individual retirement accounts for one-earner couples and restructure the dependent care tax credit. In addition, the Administration has resubmitted proposals for private-school tuition tax credits and enterprise zone tax incentives. Revenue proposals and estimates are detailed in Chapter III.

Proposed outlay changes would reduce spending by $38 billion over the 1985-1989 period. This reduction is the net effect of $85 billion in defense spending increases, $103 billion in cuts in nondefense spending programs, and a $20 billion reduction in net interest costs resulting from the tax increases and other spending changes. The proposed reductions in nondefense spending consist of:

- **$46 billion in reductions in entitlement programs.** The largest reduction is a proposal to freeze target prices in the farm price-support program. Cost-of-living increases for federal retirees would be delayed. Medicare proposals include freezing physicians' fees for one year and indexing the deductible. Reductions are also proposed for various means-tested programs, including Medicaid, Aid to Families with Dependent Children (AFDC), and Food Stamps.

- **$44 billion in lower nondefense discretionary spending.** While increases are provided for a few programs, such as assistance to Central American countries, a manned space station, and some law enforcement activities, all major elements of this category are held below baseline levels.

- **$13 billion in increased offsetting receipts.** This reflects higher premium charges for Supplementary Medical Insurance (Part B of Medicare) and a number of new user fees.

In 1985, 1986, and 1987 the proposed defense spending increases exceed the proposed cuts in nondefense programs. Only by 1988 and 1989 would the Administration's program reduce spending below the CBO baseline. The

Administration's spending program thus represents more a reordering of spending priorities than it does a major reduction in spending, as illustrated in Figure I-3. The Administration's defense and nondefense spending proposals are considered in more detail in Chapters IV and V.

The composition of spending under the Administration's budgetary program is set out in Table I-3 and Figure I-4. Total outlays would increase from $851 billion in 1984 to $1,287 billion by 1989. Of the $436 billion increase, $185 billion would be devoted to national defense programs, which would grow from 6.6 percent to 7.8 percent of GNP. Because of continuing large deficits, net interest costs would take an additional $98 billion and would rise from 3.0 percent to 3.8 percent of GNP. Nondefense spending programs--the remainder of the budget--would grow by $153 billion but would shrink from 14.3 percent of GNP in 1984 to 12.3 percent of GNP by 1989. Of the increase in nondefense spending, $114 billion--or 75 percent--is in just two programs, Social Security and Medicare.

CBO BUDGET ESTIMATES

CBO's estimates of the budgetary picture under the Administration's program are much less optimistic than the Administration's own estimates. While the Administration projects that the deficit will fall from $184 billion in 1984 to $123 billion in 1989, CBO estimates that it will grow to $248 billion. The bulk of this difference results from different long-run economic assumptions, primarily with respect to interest rates. The remainder is the result of technical estimating factors.

Differences in economic assumptions cause the CBO estimate of the budget deficit to exceed the Administration estimate by $3 billion in 1984, $8 billion in 1985, and $95 billion by 1989 (see Table I-4). Higher CBO interest-rate assumptions and the effect of economic differences on debt-service costs account for $1 billion of the difference in deficit estimates in 1984, $7 billion in 1985, and $75 billion in 1989. The remaining economic differences in outlay estimates amount to $1 billion or less in 1984, 1985, and 1986. In later years higher CBO inflation and unemployment assumptions also raise CBO's outlay and deficit estimates. Economic reestimates of Administration revenues add to the deficit by amounts ranging from $1 billion in 1984 to $7 billion in 1989. These differences result from lower CBO assumptions for corporate profits and corporate income taxes, offset only partly by higher estimates of other revenues.

Technical differences between CBO and the Administration affect the deficit estimates by only $1 billion in 1984 and $3 billion in 1985. After 1985, however, CBO's technical assumptions add substantially to the deficit

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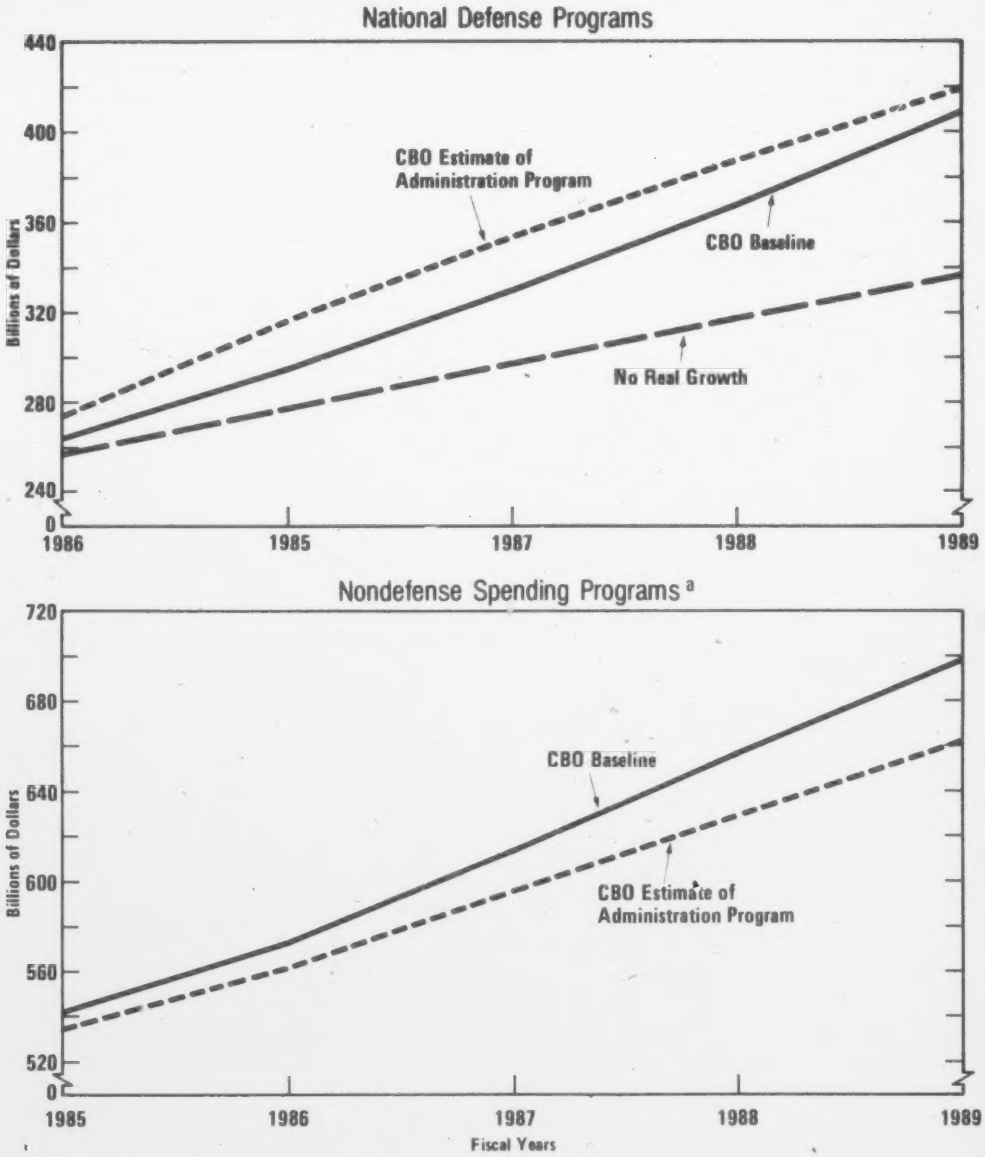
Figure I-3.

The Administration's Spending Programs



[a] Excludes net interest.

TABLE I-3. CBO ESTIMATES OF ADMINISTRATION SPENDING PROGRAM BY MAJOR CATEGORIES (By fiscal year)

	1984	1985	1986	1987	1988	1989
	In Billions of Dollars					
National Defense	235	273	315	352	387	419
Entitlements and Other Mandatory Spending	396	423	449	479	514	549
Nondefense Discretionary Spending	157	162	166	174	179	183
Net Interest	109	125	143	164	188	207
Offsetting Receipts	-46	-49	-54	-58	-64	-71
Total Budget Outlays	851	933	1,018	1,111	1,204	1,287
Off-Budget Spending	15	14	9	8	8	6
Total Outlays	866	947	1,028	1,119	1,212	1,293
	As a Percent of GNP					
National Defense	6.6	7.0	7.4	7.6	7.8	7.8
Entitlements and Other Mandatory Spending	11.1	10.8	10.6	10.4	10.3	10.2
Nondefense Discretionary Spending	4.4	4.1	3.9	3.8	3.6	3.4
Net Interest	3.0	3.2	3.4	3.6	3.8	3.8
Offsetting Receipts	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Total Budget Outlays	23.9	23.9	24.0	24.1	24.1	23.9
Off-Budget Spending	0.4	0.4	0.2	0.2	0.2	0.1
Total Outlays	24.3	24.2	24.2	24.3	24.3	24.0

SOURCE: Congressional Budget Office.

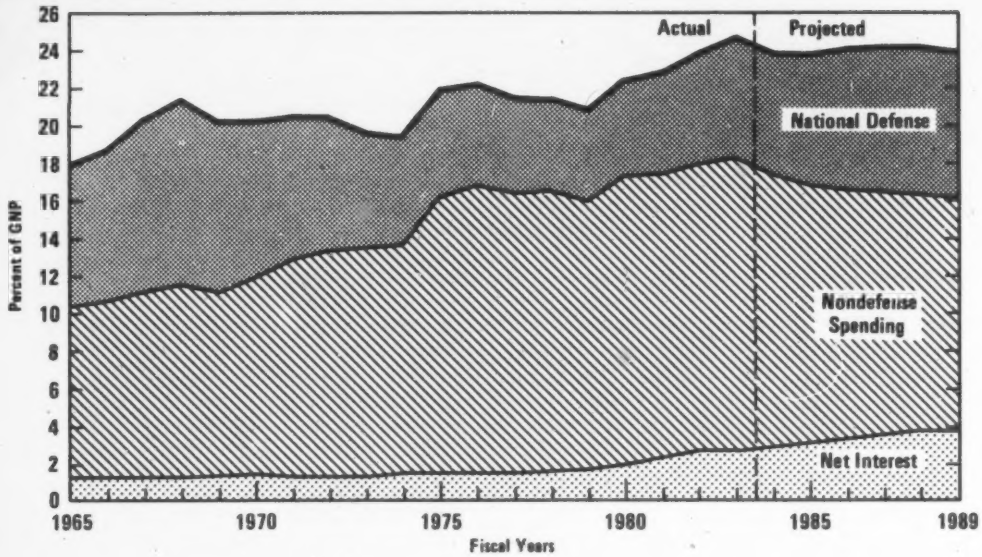
TABLE I-4. CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S BUDGET PROGRAM (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
Revenues						
Administration Estimate	670	745	815	888	978	1,060
CBO Estimate	665	741	807	878	964	1,039
Outlays						
Administration Estimate	854	925	992	1,068	1,130	1,184
CBO Estimate	851	933	1,018	1,111	1,204	1,287
Deficit						
Administration Estimate	184	180	177	180	152	123
CBO Estimate	186	192	211	233	241	248
Differences in Projections						
Revenues						
Economic	-1	-1	-2	-3	-6	-7
Technical	-4	-3	-6	-6	-9	-13
Total	-5	-4	-8	-10	-15	-21
Outlays						
Economic	2	8	17	32	59	87
Technical	-5	*	9	11	15	16
Total	-3	8	26	43	74	103
Deficit						
Economic	3	8	19	35	65	95
Technical	-1	3	15	17	24	30
Total	2	12	34	53	89	124

SOURCES: Congressional Budget Office; Office of Management and Budget.

Figure I-4.

Federal Budget Outlays Under the Administration's Program



estimates--$15 billion in 1986 and $30 billion by 1989. On the outlay side, the largest technical differences relate to defense spending and to receipts from oil and gas production activities on the Outer Continental Shelf (OCS). CBO believes that the Administration has underestimated the rate at which requested increases in defense budget authority will show up in outlays. Higher CBO defense spending rates, particularly for procurement, increase estimated outlays by $5 billion in 1986 and $10 billion in 1989. CBO also concludes that the Administration has overestimated OCS receipts by an average of $4 billion per year in the 1986-1989 period. On the revenue side, most of the technical differences are in the individual income tax estimates--$3 billion in 1986 and $13 billion by 1989. Differences between CBO and Administration revenue estimates are detailed in Chapter III; Appendix A analyzes the outlay differences.

CHAPTER II. THE ADMINISTRATION'S ECONOMIC ASSUMPTIONS

By most measures, the performance of the economy improved markedly in 1983. Growth was stronger than expected, although it was still somewhat less than that of an average postwar recovery. The unemployment rate, on the other hand, fell more rapidly than is typical in recoveries, and the continued slowing of inflation in 1983 was good news, indeed. Interest rates remained very high, however, apparently because of large current and prospective federal deficits and the Federal Reserve's anti-inflationary monetary policy. High interest rates in turn pushed up the value of the dollar in foreign exchange markets, with the result that the export and import-competing sectors of the economy did not participate in the recovery last year.

Most forecasters expect economic growth in the 4-5 percent range this year, with inflation continuing to be moderate. This is subject to some uncertainty, however, largely because of economic policy. Nothing was done in 1983 to remove the potential for a conflict between fiscal and monetary policies in the future. Efforts by the Congress and the Administration to reduce federal budget deficits accomplished very little. CBO's projected baseline deficits for coming years remain extraordinarily high and have changed little from those published last year.

THE SHORT-TERM OUTLOOK

The Administration's proposed changes in budget policy are incorporated in its short-run forecast. CBO's reestimates of these policies, discussed in Chapter I, suggest that the changes are quite small: in 1985, outlays are $3 billion above the CBO baseline and receipts rise by $8 billion. The CBO forecast, by contrast, is based on budget policies currently in place and assumes a lower path of real defense spending than the Administration's. The CBO forecast also assumes growth in the money aggregate, M1, averaging 6.0 percent during 1984 and 5.5 percent during 1985. 1/

In part because the differences in policy assumptions are small, the Administration and CBO forecasts, shown in Table I-1, are in close agree-

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1. The Administration does not publish its assumptions of growth in the money aggregates.

TABLE II-1. COMPARISON OF ADMINISTRATION AND CBO FORECASTS

Economic Variable	Actual 1983	Forecast 1984	Forecast 1985
Fourth Quarter to Fourth Quarter (percent change)			
Real GNP			
Adminstration	6.1	4.5	4.0
CBO	6.1	4.7	3.7
GNP Implicit Price Deflator			
Administration	4.1	5.0	4.7
CBO	4.1	5.3	5.1
Calendar Year Average (percent)			
Civilian Unemployment Rate			
Administration a/	9.6	7.9	7.7
CBO	9.6	7.8	7.3
3-Month Treasury Bill Rate			
Administration	8.6	8.5	7.7
CBO	8.6	8.9	8.6

a. CBO has adjusted the Administration's total unemployment rate to obtain the civilian rate.

ment. Both the Administration and CBO show real growth slowing to the 4 to 4½ percent range over the next two years, as is typical in the second stage of an expansion, and a gradual further improvement in the unemployment rate. Both forecasts also show a slight pickup in inflation this year, to the range of 5.0 to 5.3 percent, as special factors holding inflation down in 1983 begin to unwind. No further rise in inflation is expected during 1985. Finally, interest rates are projected to move down slowly from current levels. Short-term interest rates, as measured by the three-month Treasury bill rate, are forecast to average 7.7 percent in 1985 by the Administration, nearly one percentage point lower than projected by CBO.

Despite the similarity of these forecasts, an unusual amount of uncertainty surrounds them, particularly with respect to interest rates:

- Many private forecasters expect the competition between private and public demands for credit to intensify as early as 1985, resulting in higher interest rates and lower real growth than in the CBO and Administration forecasts.

- Foreign inflows of savings helped finance domestic budget deficits last year, but there is a risk that these inflows will slow, or reverse themselves, putting upward pressure on interest rates.

In addition, the outlook for monetary policy suggests continued high interest rates. In his testimony before the House Committee on Banking, Finance and Urban Affairs on February 7, 1984, Federal Reserve Chairman Volcker emphasized the importance of maintaining a strong inflation-fighting posture. He indicated that interest rates are much too high for the long-run health of the economy. But he also indicated that, given the recent strength of the economy, the continued stimulative impact of the federal deficit, and the inflationary expectations of some participants in financial markets, high interest rates are currently "appropriate." Thus interest rates may be expected to continue high in the short run barring some unexpected development such as a sag in the economy, a change in budget policy, or a shift in inflationary expectations.

THE LONG-RUN ECONOMIC ASSUMPTIONS FOR 1986-1989

The Administration and CBO have prepared longer-run economic assumptions, shown in Table II-2, for use in calculating the profile of federal government receipts and spending in the second half of the decade. The Administration's projection shows real growth averaging 4.0 percent for the 1986-1989 period. Inflation averages 4.1 percent over the period and the civilian unemployment rate moves down to 5.8 percent in 1989. The Administration takes the position, however, that the outyear projections would not be realized with policies proposed in the budget; Martin Feldstein, Chairman of the Council of Economic Advisers (CEA) testified before the House Budget Committee on February 6, 1984, that the Administration's outyear economic projection assumes "that legislative action will reduce budget deficits sharply in the years ahead." The size and composition of these policy changes have not been defined.

The CBO long-run projections for the 1986-1989 period assume moderate noncyclical real GNP growth averaging 3.4 percent. Such a growth pattern lowers the unemployment rate to about 6½ percent in 1989--a level

TABLE II-2. COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS (By calendar year)

	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)						
CBO	3651.2	3994.8	4339.0	4703.7	5083.5	5480.5
Administration	3642.4	3973.8	4319.2	4681.2	5059.0	5444.9
Difference	8.8	21.0	19.8	22.5	24.5	35.6
Real GNP (1972 dollars, percent change, year over year)						
CBO	5.4	4.1	3.5	3.5	3.4	3.3
Administration	5.3	4.1	4.0	4.0	4.0	3.9
Difference	0.1	0.0	-0.5	-0.5	-0.6	-0.6
GNP Deflator (percent change, year over year)						
CBO	4.7	5.1	4.9	4.7	4.5	4.3
Administration	4.5	4.8	4.5	4.2	3.9	3.6
Difference	0.2	0.3	0.4	0.5	0.6	0.7
Consumer Price Index (percent change, year over year) a/						
CBO	4.5	5.0	4.9	4.7	4.5	4.3
Administration	4.4	4.6	4.5	4.2	3.9	3.6
Difference	0.1	0.4	0.4	0.5	0.6	0.7
Civilian Unemployment Rate (percent, annual average)						
CBO	7.8	7.3	7.0	6.8	6.6	6.5
Administration b/	7.9	7.7	7.5	6.9	6.2	5.8
Difference	-0.1	-0.4	-0.5	-0.1	0.4	0.7
3-Month Treasury Bills (percent, annual average)						
CBO	8.9	8.6	8.4	8.2	8.0	7.8
Administration	8.5	7.7	7.1	6.2	5.5	5.0
Difference	0.4	0.9	1.3	2.0	2.5	2.8
Inflation-Adjusted Interest Rates c/						
CBO	4.2	3.5	3.5	3.5	3.5	3.5
Administration	4.0	2.9	2.6	2.0	1.6	1.4
Difference	0.2	0.6	0.9	1.5	1.9	2.1

a. Consumer Price Index for urban wage earners and clerical workers.

b. The Administration publishes only the overall unemployment rate. The civilian adjustment is made by CBO.

c. Defined here as the Treasury bill rate minus growth in the GNP deflator.

thought by many economists to be near the lowest rate that can be attained without provoking additional inflation. This rate of growth is not a forecast or a CBO judgment concerning appropriate growth rates. Instead, it is based on historical growth trends--the average economic growth rate during the seven-year period following postwar recessions--and is intended to serve only as a benchmark for evaluating budget policy. 2/

Although the short-run forecasts are quite similar, the Administration and CBO longer-run projections differ significantly. Both show some gradual decrease in inflation and nominal GNP growth, in contrast to the projections of many private forecasters. In this regard they are broadly consistent with statements by both the Administration and the monetary authorities calling for moderate growth and gradually declining inflation. But the tradeoff between real growth and inflation is more optimistic in the Administration's assumptions: annual real growth rates average 0.5 percent higher and inflation 0.6 percent lower in the 1986-1989 period. Consequently, the unemployment rate drops more rapidly in the Administration's projection.

The interest-rate assumptions, as reflected in the three-month Treasury bill rate, are very different (see Figure II-1). Both real and nominal rates in the Adminstration's projection fall well below those in

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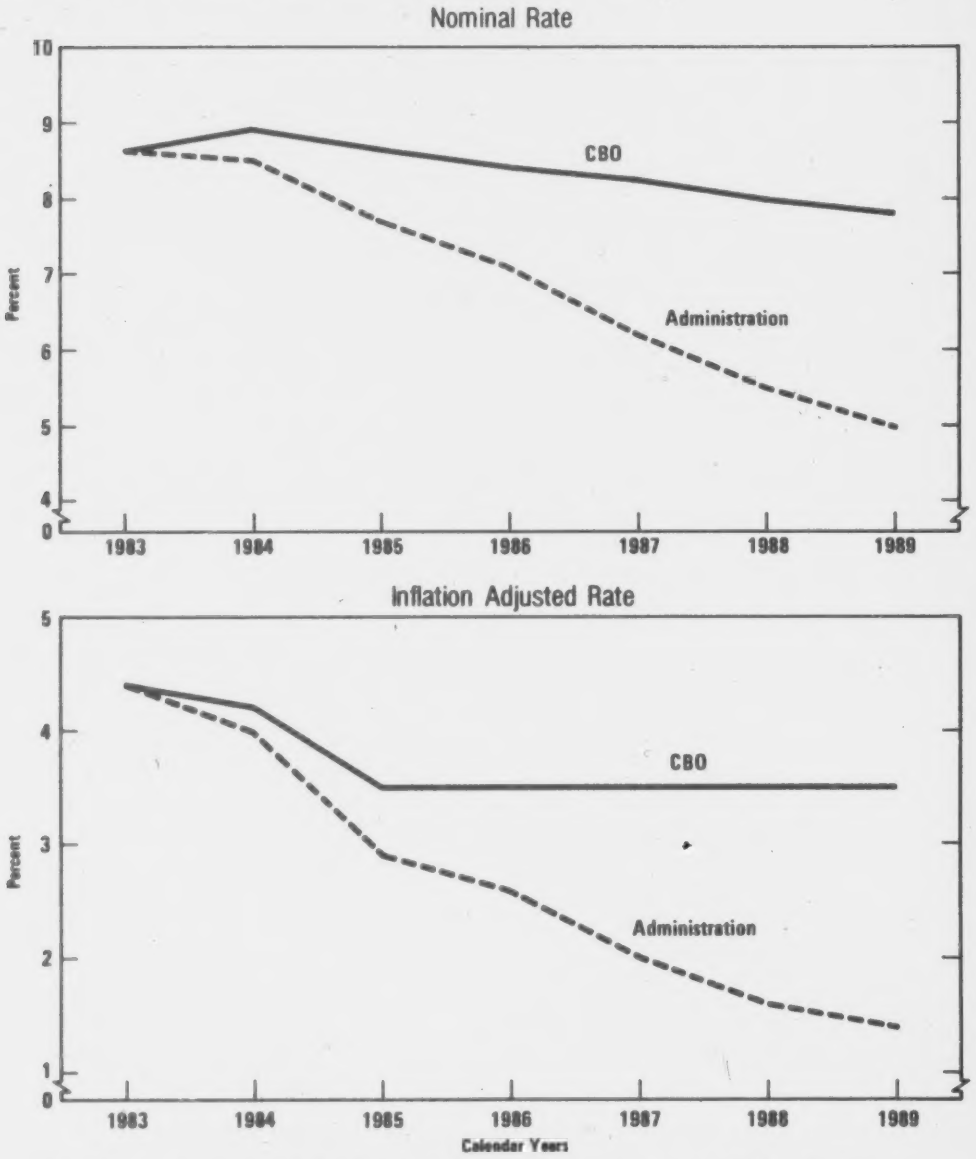
2. The projected growth rate from the recession trough in the fourth quarter of 1982 to 1989 is precisely equal to the average growth rate for seven-year periods following the trough quarter of six previous postwar recessions (4.0 percent):

Trough Quarter of Recession	Average Annual Real GNP Growth During Seven Years Following Trough (percent)
1949:4	4.7
1954:2	3.0
1958:2	4.6
1961:1	5.0
1970:4	3.6
1975:1	3.0
Average	4.0

The averages for different periods do, however, vary substantially, ranging from 5 percent for the recovery beginning in 1961 to about 3 percent for the 1954 and 1975 recoveries.

Figure II-1.
Projections of Three-Month Treasury Bill Rates



SOURCES: Congressional Budget Office, *The Economic Outlook* (February 1984); *Budget of the United States Government, Fiscal Year 1985.*

CBO's. The Administration's real interest rates, defined as the short-term Treasury bill rate less growth in the GNP deflator, average 2.0 percent below the CBO projections in 1988 and 1989. Apparently, the difference in interest rate projections stems partially from budget assumptions. In his February 7 testimony before the House Banking Committee, CEA Chairman Feldstein pointed out: "If sharp deficit reductions are not enacted, the interest rates are not likely to fall over the next five years as we have projected and growth of real GNP is likely to be slower than we have assumed."

Thus both the Administration and CBO agree that without substantial changes in fiscal policy, interest rates are likely to remain very high in the outyears. In the face of an expansive fiscal policy, the Federal Reserve's inflation-fighting posture may also necessitate continued upward pressure on interest rates during the next several years.

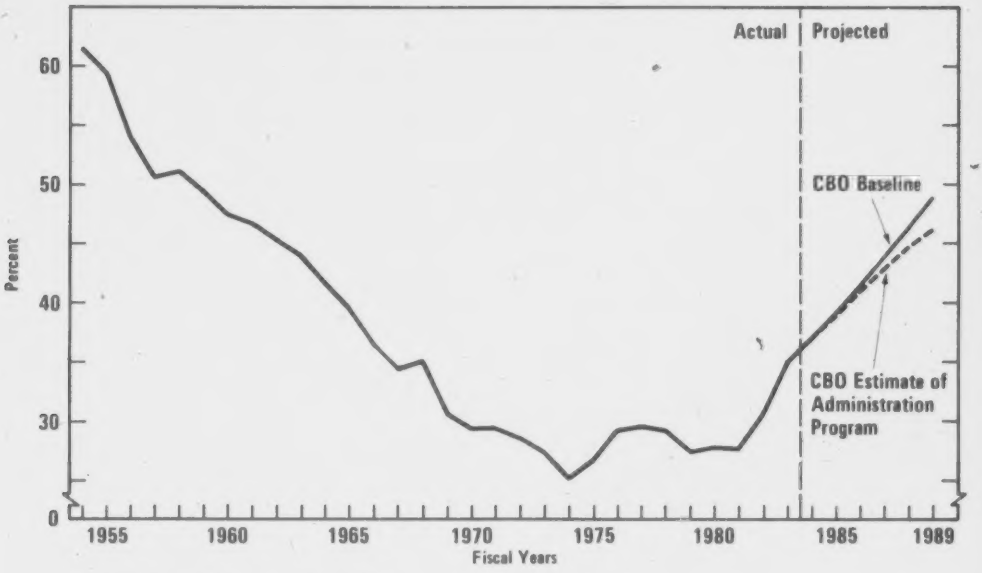
CONSEQUENCES OF LARGE DEFICITS

Federal deficits of the magnitude shown in the Administration's budget and in the CBO baseline projections would have major consequences both for the economy and for future budgetary choices. Most economists agree that federal deficits of the size projected will keep interest rates higher than they would be otherwise. The effect would be particularly strong as the economy approached full employment (or the limits to growth set by monetary policy), where public and private borrowing would compete for a relatively fixed level of saving. Even in the present situation of less than full employment, deficits are likely to raise interest rates. A few analysts contend that there is no historical evidence for a link between deficits and interest rates. But one should not expect to find in historical data a simple association between deficits and interest rates. Previous deficits experienced during peacetime have been much smaller than those now projected, and their impact on interest rates has often been overwhelmed by recessions, Federal Reserve policies, or international capital flows.

The current and prospective deficits are extremely large relative to past history. In fiscal year 1983, the federal deficit was about 107 percent of domestic net private saving and 34 percent of gross private saving. CBO's forecast implies that the deficits projected by the Administration, as reestimated by CBO, would be 79 percent of net private savings and 29 percent of gross private savings during the 1984-1985 period. Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates. It should be emphasized that these capital inflows are not a costless remedy for deficits. If the capital inflow continued for a long time, foreign claims on U.S. output (interest and dividend payments to foreigners) could rise to such a level that they would reduce the U.S. standard of living

Figure II-2.

Federal Debt Held by the Public as a Percentage of GNP



SOURCE: Congressional Budget Office.

significantly below what it would be with less government borrowing and lower capital inflows.

High interest rates, if they persist, are likely to reduce capital accumulation. Although the cyclical rise in demands and increased capacity utilization rates are now providing a strong stimulus to investment, this may eventually be offset by the retarding effect of high interest rates on investment in structures. Over time a reduction in the capital-output ratio will retard growth in productivity, the major source of rising living standards.

Another aspect of high deficits is the growing cost of financing them. The most striking feature of both sets of budget projections is the extremely rapid growth in outlays for interest on the debt (see Chapter I). Net interest costs, which were between 1 and 2 percent of GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal year 1983 to 3.8 percent in 1989. As a consequence, the stock of federal debt outstanding rises dramatically in the outyears (see Figure II-2 and Table II-3). The CBO

TABLE II-3. FEDERAL DEBT HELD BY THE PUBLIC

	1984	1985	1986	1987	1988	1989
			In Billions of Dollars			
CBO Baseline a/	1,329	1,538	1,768	2,028	2,315	2,636
CBO Estimate of Administration Program	1,326	1,529	1,749	1,990	2,237	2,490
			As a Percent of GNP			
CBO Baseline a/	37.3	39.3	41.6	44.0	46.4	49.0
CBO Estimate of Administration Program	37.2	39.1	41.1	43.1	44.9	46.3

a. The CBO baseline figures are preliminary revisions of those appearing in Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1985-1989 (February 1984).

baseline and Administration estimates show federal debt rising to between 46 and 49 percent of GNP in 1989. This ratio has only risen above 30 percent of GNP four times in the history of the republic. 3/ In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

The rapid rise in the debt-to-GNP ratio also makes the future deficit outlook highly sensitive to interest rates, one of the hardest economic variables to forecast. A one-percentage-point error in the forecast, if continued through the projection period, implies a $30 billion error in the projection of the 1989 deficit.

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3. For a discussion of deficits, debt, and their long-run effects on the economy, see Congressional Budget Office, The Economic Outlook (February 1984), Chapter III.

CHAPTER III. THE ADMINISTRATION'S REVENUE PROPOSALS AND ESTIMATES

The Administration's fiscal year 1985 budget proposes a more modest revenue increase than did its 1984 budget. Most of this year's revenue proposals were contained in last year's budget and have been considered by the Congress. In the first year of implementation, these proposals would increase revenues by $8 billion; by the fifth year, they would increase revenues by $24 billion (see Table III-1). Using economic and technical estimating assumptions somewhat different from the Administration's, CBO projects slightly lower total revenue growth than does the Administration for the 1985-1989 period. For 1987, the CBO estimate of the President's budget is $10 billion below the Administration estimate; by 1989, it is $21 billion lower.

TABLE III-1. PROJECTED REVENUES UNDER THE ADMINISTRATION'S 1985 BUDGET PROPOSALS
(By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
CBO Baseline Revenue Projection a/	663	733	795	863	945	1,016
Administration Proposals						
Revenue increases	3	10	16	20	24	29
Revenue reductions	-1	-2	-4	-5	-5	-5
Subtotal, revenue proposals	2	8	12	15	18	24
President's 1985 Budget as Estimated by CBO	665	741	807	878	964	1,039

SOURCES: Budget of the Unitd States Government for Fiscal Year 1985 and Congressional Budget Office.

a. Revenues generated under existing tax law with two exceptions: taxes for the aviation trust fund are assumed extended beyond 1987 at current rates, and likewise, highway trust fund taxes beyond 1988.

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THE PRESIDENT'S REVENUE PROPOSALS

The President's 1985 budget proposes net tax increases growing from $8 billion in 1985 to $24 billion, or 0.4 percent of GNP, in 1989 (see Table III-1). 1/ The only new proposals with significant revenue effects are the establishment of a petroleum overcharge restitution fund and the unemployment insurance coverage of railroad employees; together, these measures raise about $3 billion over the five-year period (see Table III-2). Other proposals are similar to previous Administrations' or to other legislative plans considered by the Congress.

The budget describes the President's revenue proposals as "... measures to strengthen the revenue base and adjust certain unwarranted or no longer justifiable features of the Internal Revenue Code." 2/ Though some proposals, such as the taxation of employer-provided health insurance premiums (also proposed last year), would significantly expand the personal income tax base, the main features of the Administration's revenue proposals are the adjustment or extension of tax incentives, the completion of structural tax code changes recently considered by the Congress, such as revision in life insurance company taxation and restriction of leasing by tax-exempt entities, and the limitation of tax shelters and abuses.

The President has suggested that further changes in the tax code might be supported by the Administration. The Economic Report of the President mentions that "... further improvement and simplification of our tax system are sorely needed," and that the Secretary of Treasury has been asked to develop a plan to make the tax system "... fairer, simpler, and less of a burden on our Nation's economy." 3/

Proposals of three types account for most of the revenue increases the Administration envisions:

- o Taxation of health insurance premiums, which accounts for more than half of the increases;

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1. The revenue effects of the extension of and the removal of the cap from the hazardous substance trust fund (superfund) taxes after September 30, 1985, and of the federal pay increases proposed by the Administration (neither of which are not included in CBO baseline revenues) are treated here as Administration proposals.

2. See Budget of the United States Government, Fiscal Year 1985 (February 1984), page 3-54.

3. See Economic Report of the President (February 1984), p. 7.

- o "Structural reform" proposals, limitations on tax-exempt leasing and on private-purpose tax-exempt bonds; and

- o Restrictions on tax shelters and on accounting and corporate tax abuses.

At the same time, however, several Administration proposals would reduce revenues (see Tables III-1 and III-2). The most significant revenue-losing proposal is the revision in life insurance taxation rules; this accounts for about one-quarter of the proposed reduction in revenues. Other proposals that adjust or extend current tax incentives, or create new ones, result in relatively minor revenue losses. Brief discussions of some of the significant proposals follow. Unless stated otherwise, these proposals are assumed to become effective at the beginning of 1985.

Tax Employer-Provided Health Insurance Premiums

Taxation of premiums for employment-related health insurance would increase revenues by $18 billion over the 1985-1987 period and by $40 billion through 1989. About 70 percent of the revenue increase would be in income taxes, the remainder, in payroll taxes. Under this proposal, employees would be taxed on employer-paid health insurance premiums in excess of monthly thresholds of $175 for family plans and $70 for single-person plans. The thresholds would be indexed to the annual increase in the Consumer Price Index. Revenues in years after 1985 would grow rapidly because premiums are likely to increase at about 10.5 percent a year, while the maximum tax-exempt employer contributions would rise by only about 5 percent a year.

The Administration estimates that the tax on employer-paid premiums in excess of the ceilings would initially affect about 38 percent of all workers with job-related health benefits. This proportion would rise to about 55 percent by 1989. On an individual taxpayer basis, the increase in taxes would be higher for persons in higher income brackets, both because of the higher employer-paid premiums they receive and because of the higher tax rates they pay on additions to income ("marginal tax rates"). Overall, though, more than 60 percent of the increased tax liability would be borne by persons with annual incomes between $20,000 and $60,000.

Compared to a similar proposal made by the Administration last year, this proposal would affect more employees and raise more revenue, because the proposed ceilings on tax-exempt employer-paid health insurance premiums have not been adjusted to reflect inflation in the intervening year.

TABLE III-2. REVENUE LEGISLATION AND ADMINISTRATIVE ACTION PROPOSED BY THE ADMINISTRATION (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
Revenue Increase Proposals						
Extend and remove cap from superfund taxes a/	0	0	0.2	0.2	0.2	0.2
Tax health insurance premiums	0	3.9	6.5	8.0	9.7	12.1
Increase federal employees' contributions to retirement	0	0.7	1.4	1.5	1.6	1.7
Cover of railroad employees under unemployment insurance	0	0.1	0.1	0.1	0.2	0.2
Restrict leasing by tax-exempt entities	1.2	1.7	2.7	4.0	5.4	7.0
Limit use of private-purpose tax-exempt bonds	*	0.2	0.4	0.8	1.0	1.3
Restrict tax shelters, accounting and corporate tax abuses	0.8	3.2	4.3	4.7	5.7	6.6
Establish petroleum overcharge restitution fund	0.5	0.5	0.5	0.5	0	0
Other	*	0.1	*	0.1	0.1	-0.1
Subtotal, revenue increase proposals	2.5	10.3	16.1	19.8	23.9	28.9

(Continued)

a. Included in Administration current services receipts, but not included in CBO baseline receipts.

* Less than $50 million.

SOURCE: Budget of the United States Government for Fiscal Year 1985 and Congressional Budget Office.

TABLE III-2. (Continued)

	1984	1985	1986	1987	1988	1989
Revenue Reduction Proposals						
Administration's federal pay proposal b/	0	-0.1	-0.1	-0.1	-0.1	-0.1
Revise life insurance company taxation	-0.5	-0.8	-0.9	-1.0	-1.1	-1.2
Establish education savings accounts	0	*	-0.1	-0.3	-0.5	-0.7
Institute tuition tax credit	0	-0.3	-0.6	-0.9	-0.9	-0.9
"Women's initiative" c/	0	-0.3	-0.9	-0.9	-1.0	-1.0
Establish enterprise zones	0	-0.1	-0.4	-0.8	-1.0	-1.1
Extend targeted jobs tax credit one year	0	-0.2	-0.4	-0.4	-0.2	-0.1
Extend incremental R&D tax credit three years	0	0	-0.4	-0.7	-0.8	-0.4
Extend moratorium on research and experimental source allocation	-0.1	-0.1	-0.1	0	0	0
Other	*	*	*	*	*	*
Subtotal, revenue reduction proposals	-0.5	-2.0	-3.9	-5.0	-5.5	-5.3
Total Proposed Legislation and Administrative Revenue Action	**2.0**	**8.3**	**12.3**	**14.8**	**18.4**	**23.6**

b. Effect of proposed federal pay increases on payroll taxes and retirement contributions; included in Administration "receipts under existing legislation," but not included in Administration current services receipts.

c. Includes a proposed increase in the limit on annual IRA contributions for one-earner couples and changes in the dependent-care credit.

Increase Federal Employees' Contributions Toward Retirement

The Administration's proposed increase in contribution rates to the federal employee retirement plan would raise $4 billion over the 1985-1987 period and $7 billion through 1989. Federal employees now contribute 7 percent of their wages and salaries to the Civil Service Retirement system. The Administration would increase the contribution rate to 8 percent as of October 1985 and to 9 percent as of October 1986. (This proposal includes employees of the District of Columbia who are under CSR.) The President's 1984 budget included a similar proposal, calling for higher contribution rates of 9 percent and 11 percent, effective October 1983 and 1984, respectively.

Cover Railroad Employees Under Unemployment Insurance

The Administration proposes that railroad employees be covered under the regular unemployment insurance program, while current railroad unemployment insurance taxes be retained to pay back the substantial loans that the Railroad Retirement Account has made to the Railroad Unemployment Insurance (RRUI) program. The Railroad Retirement Solvency Act of 1983 (Public Law 98-76) prohibits further such lending, effective September 30, 1985, but without further action, RRUI will become insolvent. A committee established under Public Law 98-76 is to submit a report on the program to the Congress no later than April 1, 1984; to date, however, the committee has made no specific proposals.

The Administration estimates that the proposal would increase revenues by upwards of $1 billion over the five-year period. CBO has not reestimated the revenue effects of the proposal because of the lack of specific detail. CBO's estimate of such a proposal is unlikely to be very different, however.

Restrict Leasing by Tax-Exempt Entities

The President's budget would reduce depreciation allowances under the Accelerated Cost Recovery System and investment tax credits for sale-leasebacks of property currently used by tax-exempt institutions, including federal agencies. The proposal also covers leases of property financed by tax-exempt bonds. Similar proposals have been approved by committees in both Houses during the last session of the Congress.

The Administration estimates that these measures would raise revenues by $8 billion over the 1985-1987 period and by $21 billion through 1989. Comparable Congressional proposals showed smaller revenue gains, attribu-

table for the most part to a number of transitional rules in the legislation that exempted certain projects from their provisions. The Administration's proposal assumes that all transactions entered into after May 23, 1983, would be affected, without exception.

Limit Use of Private-Purpose Tax-Exempt Bonds

The Administration has proposed several limitations on the use of tax-exempt bonds providing loans for private businesses and for students. These restrictions are substantially the same as those proposed in the still-pending Tax Reform Act of 1983, as amended and approved by the Committee on Ways and Means in November 1983 under H.R. 4170. These proposals call for limits, based on state population, on the volume of tax-exempt industrial revenue bonds (IRBs) and on student loan bonds. The annual volume limits for each state would amount to $150 per capita from 1984 through 1986, rising to $100 per capita beginning in 1987, when use of small issue IRBs is scheduled to end. Additional restrictions include requiring that IRBs be available to acquire existing facilities only if some rehabilitation takes place, prohibiting the use of more than 25 percent of the proceeds of an IRB issue to acquire land, and limiting the availability of new IRB financing to firms with outstanding tax-exempt debt of less than $40 million.

The Administration estimates that these changes would raise revenues by $1 billion over the 1985-1987 period and by $4 billion through 1989. These estimates assume continuation of the "sunset" on mortgage revenue bonds, which effectively ruled out new issues of these bonds as of January 1, 1984. Enactment of IRB and student loan bond restrictions might be accompanied by a five-year extension of mortgage revenue bonds (as in H.R. 4170). Such an extension is estimated to reduce revenues by about $1 billion in the 1985-1987 period, cancelling out much of the potential short-term revenue gains from the restrictions on other bonds. For the 1985-1989 period, the net revenue gain, including extension, is estimated at less than $0.5 billion.

Restrict Tax Shelter, Accounting and Corporate Tax Abuse

Some 25 proposed changes to the tax code would limit transactions that have no economic substance other than tax avoidance ("tax arbitrage" transactions). Most of the proposals have been discussed in the tax-writing committees during the past year. Several were included in H.R. 4170 (see above), and many of them are expected to be considered by the Congress early this year. One proposal would tax the accrued gain on appreciated property that is distributed as a corporate dividend, such as the units in an

oil royalty trust. This provision would make such trusts less attractive by increasing the cost of establishing them. These proposals are estimated to increase revenues by $12 billion over the 1985-1987 period and by $25 billion over five years.

Establish Petroleum Overcharge Restitution Fund

The Administration proposes to create a special fund to handle monies recovered from oil companies found to have been in violation of price controls in the 1970s. These monies are currently held in escrow accounts. Although attempts are made to identify the victims of overcharges and to compensate them, doing so is not always possible. In those cases in which the overcharges could be measured but not allocated to particular victims, the balance would be remitted by the oil companies to the government and put in this fund.

The Administration's estimate of a revenue increase of $2 billion from the creation of the fund is reasonable, according to CBO's calculation. But because of the likely large numbers of claims and the slow administrative process of dealing with them--at times, including court litigation--CBO has spread the increase evenly over the 1984-1987 period, attributing $0.5 billion in revenue gains to each year.

Revise Life Insurance Company Taxes

Before 1982, the tax treatment of life insurance companies and their products was based on a system adopted in 1959, despite major changes in the industry and the economy in the decades between. The life insurance provisions of the Tax Equity and Fiscal Responsibility Act of 1982 began the process of reforming and simplifying life insurance company taxation by repealing the modified coinsurance provisions that had become a major source of unintended tax reduction, and by changing the tax treatment of some life insurance company products. In addition, several stopgap provisions were enacted to stabilize the industry's tax burden for a two-year period while permanent legislation was developed. At the end of 1983, the rules under which life insurance companies are taxed reverted to 1959 law.

The Administration's proposals--estimated to reduce revenues by $3 billion over the 1985-1987 period and by $5 billion by 1989--are similar to ones contained in H.R. 4170 and S. 1992 introduced in the Senate Finance Committee during the 98th Congress. These bills included a special deduction for life insurance companies that would allow all companies to reduce their taxable life insurance income by 25 percent. The Administra-

tion proposal would scale this deduction back to 20 percent. It would also eliminate a provision of the avovementioned bills that would treat as taxable income to the holder the deferred income of an annuity's contract if the holder dies before the annuity's starting date. In addition, it would include limits on the deduction of interest on policyholder loans more stringent than the limits included in the bills.

Establish Education Savings Accounts

The earnings of proposed educational savings accounts--also proposed by the Administration in its 1984 budget--would be tax exempt so long as the proceeds were used for post-secondary education. This year's proposal broadens acceptable expenditures to include graduate school and possibly trade school tuition, and tuition for part-time as well as full-time students. The main revenue loss from education saving accounts would be in later years. The Administration estimates a revenue loss of $0.5 billion over the 1985-1987 period; however, by 1989, the estimated loss would have risen to $0.7 billion a year. Revenue losses could be expected to continue growing rapidly for 10 to 20 years, as savings in the account balances accumulate.

The Administration envisions a separate account set up for each dependent child with contributions permitted up to $1,000 per child per year for children under 18 years of age. The $1,000 contribution limit would decline for contributors with adjusted gross incomes above $40,000 and would reach zero for those with incomes of $60,000 and above. Education savings accounts would encourage families to save for college and would reduce the burden of doing so for families who would save in any event. A middle-income family saving regularly for 18 years would reduce its college costs by 18 percent compared to saving the same money in a taxable account.

In fact, however, parents do not need to wait for educational savings accounts to start tax-exempt saving for their children. Under existing law, parents can use trusts or gifts to minors to set up savings accounts in their children's names. With an 8 percent interest rate, a child could hold $12,500 before earning enough to pay tax. With four-year costs for many colleges already well in excess of $12,500, however, families with the resources to save more than that amount per child could benefit from education savings accounts. Gifts to minors come under the child's control at age 18, and they can be used for whatever purpose the child chooses, though parents might prefer to restrict use of their savings to education. Though trusts can be restrictive in their use, they tend to be more complicated and costly to set up than education savings accounts would be.

A number of bills have been proposed in past sessions of the Congress that would provide tax-favored accounts for education. Unlike the Administration's proposal, most plans would make contributions tax deductible, and would subsequently recapture contributions and interest by requiring the child to add these to his post-secondary-school income. Such proposals usually entail larger revenue losses than would the Administration's current plan.

Institute a Tuition Tax Credit

The Administration proposes a nonrefundable tax credit that would be available to families sending their children to nonpublic elementary and secondary schools. The credit would equal up to 50 percent of tuition costs. Following a phase-in period, the credit would be capped at $300 per dependent and phased down for taxpayers with more than $40,000 in annual adjusted gross incomes, with a zero credit for taxpayers with annual incomes above $60,000.

The Congress has considered such credits before. Tuition tax credit legislation was defeated in the Senate in 1982 and 1983, and the Administration proposed a similar tuition tax credit in its 1984 budget. The current proposal would reduce revenues by $2 billion over the 1985-1987 period and by $4 billion over the five-year period.

Increase Individual Retirement Account Limit for One-Earner Couples

As part of its "women's initiative," the Administration proposes to raise the annual limit on tax-deferred contributions to individual retirement accounts (IRAs) for one-earner couples. Under current law, taxpayers may contribute to IRAs the lesser of $2,000 or the taxpayer's yearly income. The Administration's plan would raise that limit either to $4,000 or to the employed spouses' qualified earned income, whichever is less. Thus, couples with two employed spouses can deduct up to $4,000 per year, while couples with only one spouse working outside the home and filing a joint return can deduct up to $2,250. Justifying the raised limit for tax-deferred IRA contributions, one can argue that couples with one earner will need as much retirement income as two-earner couples. The lower spousal limit currently in force bears most heavily on couples with dependent children. This proposal would reduce revenues by $2 billion over the 1985-1987 period and by $4 billion over five years.

Revise the Dependent-Care Tax Credit

Under current tax law, taxpayers may claim a tax credit for dependent-care expenses up to $2,400 for one child and $4,800 for two or more children. For families with incomes below $10,000, the credit is 30 percent of employment-related expenses up to a maximum credit of $1,440 a year for two or more dependents; it phases down to 20 percent for those with incomes over $28,000. The Administration proposes to raise the credit to 40 percent for taxpayers with incomes below $10,000 and then phase out the credit entirely at incomes above $60,000. By reducing the credit at higher incomes while expanding it at lower incomes, the proposal keeps the additional revenue loss small relative to the nearly $2 billion annual loss for the credit under current law. The Administration estimates the additional revenue loss to equal $0.4 billion over the 1985-1989 period.

Establish Enterprise Zones

The Administration proposes that up to 75 small, economically distressed geographic areas each year be designated "enterprise zones." Within these zones, federal tax and other incentives would be provided to stimulate private-sector economic activity, to help redevelop deteriorated areas, and to stimulate employment. Within the zones, employers would receive tax credits based on the number of economically disadvantaged persons they hire. Employees of zone firms would be allowed a tax credit equal to 5 percent of the first $10,500 of wages earned in the zone. The regular investment tax credit now in effect would be increased by 50 percent for machinery and equipment used in zones; a 10 percent investment tax credit would be allowed for new construction and reconstruction of buildings within zones; capital gains on business property and interests in businesses would be exempt from taxation; and small issue tax-exempt bonds could be used to finance investment in the zones after the 1986 sunset date applicable for these bonds elsewhere. This proposal is estimated to decrease revenues by $1 billion over the 1985-1987 period and by $3 billion over five years. These and similar proposals are contained in bills that have been drafted in both Houses of Congress.

Extend the Targeted Jobs Tax Credit

The Administration proposes a one-year extension of the Targeted Jobs Tax Credit (TJTC), which provides corporate income tax reductions to hire certain jobless and generally low-skilled persons. Employers who hire a member of any one of nine targeted groups may claim credits of up to $3,000 in the first year and $1,500 in the second. (Deductions for wage and

salary expenses must be reduced by the amount of the credit, however.) The legislation authorizing TJTCs is scheduled to expire at the end of 1984. The proposal would reduce revenues by slightly more than $1 billion over the five-year period.

The credit is designed in part to offset the effect on the employment of unskilled workers of minimum wage laws. Evidence suggests that the current TJTC has not been very effective in stimulating employment, however, owing in part to problems with its implementation. Changes in implementation or larger tax reductions might be necessary to encourage its use by large numbers of employers.

Modify Research and Development Tax Provisions

A 25 percent credit for corporations' research and development (R&D) expenditures enacted as part of the Economic Recovery Tax Act of 1981 is scheduled to expire at the end of 1985. (The credit is only for incremental expenditures over some base level, as defined by the law.) The Administration proposes to extend the credit through 1988. Because of the difficulties in defining R&D expenditures, the Administration also proposes to modify the definition of eligible expenditures so that only those costs incurred in the development of new or significantly improved products or processes would qualify. The extension would reduce revenues by $2 billion over the 1986-1989 period.

In addition, the Administration proposes to extend for two years the Congressionally imposed suspension of regulations regarding the allocation of research and experimental expenditures between domestic- and foreign-source corporate income. At present, firms are allowed to charge all domestic research and experimental expenditures against U.S. income--no apportionment is required. The regulations would require some allocation, generally reducing foreign-source corporate income and increasing U.S. income, thereby increasing corporate income taxes. The Administration would like to study the regulations further. A five-year extension was suggested last year by the Subcommittee on Oversight of the House Ways and Means Committee, but it was not acted on by the full Committee. The proposed two-year extension of the moratorium would reduce revenues by $0.2 billion over the 1984-1986 period.

Institute Trusts for Investment in Mortgages

The Administration proposes to create a new tax classification for entities investing in mortgages. Called Trusts for Investments in Mortgages

(TIMs), these entities would function like mutual funds for mortgages. Investors would buy shares in a TIM, which would actively manage a mortgage portfolio, and the trust would be exempt from tax on income distributed to its shareholders (as is the case for mutual funds). Under current law, entities actively buying and selling mortgages are taxable. Those that passively hold mortgages are tax exempt but must be dissolved as homeowners prepay their mortgages.

The Administration proposes to deny TIM benefits to the three federally related institutions that currently dominate the buying and selling of mortgages: the Government National Mortgage Association, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. These institutions could not manage TIMs, and their own securities or securities backed by them would not be qualified assets for TIMs. Furthermore, existing TIM-like entities would be penalized for future purchases of securities issued or backed by the federally related institutions. To curtail federal influence in credit markets, the Administration proposes to exclude the federally related institutions from TIM benefits. Others would like to extend the federal influence in combination with TIMs to attract more funds to housing at lower rates.

In 1983, a TIMs bill was introduced in the Senate. That bill, however, would have allowed the three federally related entities to benefit indirectly from TIMs. TIMs were also proposed by the President's Commission on Housing in its 1982 report. Because most mortgages are already held in tax-exempt or lightly taxed entities, the proposal is expected to entail only a negligible revenue loss.

DIFFERENCES IN ADMINISTRATION AND CBO REVENUE ESTIMATES

About one-third of the difference between the CBO and Administration revenue estimates is attributable to differences in economic assumptions (see Table III-3). Most of the remaining two-thirds arises from technical assumptions that include differences about administrative actions, about taxpayers' or general business behavior, and about effective tax rates.

The CBO analysis corroborates the Administration's estimates of the revenue effects of most of its tax proposals. Two estimates differ, however. The revenue effect of increasing federal employees' contributions to the Civil Service Retirement system (also treated in Chapter V) has been reestimated on the basis of CBO's economic assumptions; and the revenue increase from a proposed petroleum overcharge restitution fund has been assumed to spread over four years instead of accruing entirely in 1985.

TABLE III-3. CBO REESTIMATES OF THE ADMINISTRATION'S REVENUE PROJECTIONS (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
President's 1985 Budget, Administration Estimate	670	745	815	888	978	1,060
CBO Reestimates						
Different economic assumptions						
Individual income taxes	*	3	3	2	2	4
Corporate income taxes	-3	-9	-12	-12	-15	-17
Social insurance taxes	1	4	5	3	1	-2
Other taxes	*	2	3	4	6	7
Subtotal	-1	-1	-2	-3	-6	-7
Technical reestimates						
Individual income taxes	-1	-1	-3	-5	-8	-13
Corporate income taxes	-1	-2	-3	-1	1	1
Social insurance taxes	-1	*	*	1	1	2
Other taxes	-1	*	*	-1	-2	-3
Subtotal	-4	-3	-6	-6	-9	-13
Total Reestimates	-5	-4	-8	-10	-15	-21
President's 1985 Budget as Estimated by CBO	665	741	807	878	964	1,039

* Less than $500 million.

SOURCES: Budget of the United States Government for Fiscal Year 1985 and Congressional Budget Office.

Economic Assumptions

Revenue estimates are directly related to projected tax bases--wages and salaries, personal property income, corporate profits, and sales. Interest rates affect revenue through Federal Reserve payments (mostly return of earnings from federal government securities) and through income taxes

by way of interest income. The rate of inflation also directly affects revenues through the indexation of the taxable wage base for Social Security taxes and, beginning in 1985, of the individual income tax brackets, zero bracket amount, and personal exemptions, and through the valuation of corporate inventories and capital consumption. Investment directly affects corporate income taxes through deductions and credits for newly acquired depreciable assets.

CBO's economic projections differ somewhat from the Administration's. CBO projects slightly higher gross national product (GNP), with slightly higher prices and generally lower real output than the Administration projects. (CBO's projected oil prices, however, are slightly lower.) CBO's projection of taxable personal income is higher than the Administration's, although CBO's wage and salary component falls below the Administration's by 1988. CBO's projection of corporate profits is generally lower than the Administration's, while its interest rate projections are considerably higher throughout the five-year period. The differences in the CBO revenue reestimates attributable to economic assumptions are calculated by using Administration economic projections in CBO's estimating procedures. The differences between these revenue estimates and CBO's estimates, using common procedures, arise from differences in economic projections. (The remaining differences between CBO and Administration revenue estimates are attributed to technical factors.)

CBO's economic assumptions cause revenue projections to be lower in each year, by amounts ranging from $1 billion in 1985 to $7 billion in 1989 (see Table III-3). CBO's projection of lower corporate income tax revenues attributable to a lower projection of corporate profits (before tax and before adjusting for Accelerated Cost Recovery System deductions) more than account for the difference. The lower profits level explains most of the total difference between CBO and Administration corporate income tax estimates through 1987, and it accounts for more than the total difference for 1988 and 1989.

CBO's projection of taxable personal income is above the Administration's projections throughout the 1985-1989 period. Considered alone, this factor would raise the CBO estimates of individual income tax revenues above the Administration estimates by amounts ranging from $2 billion to $4 billion a year. After 1986, however, technical differences in estimation procedures more than offset the differences caused by economic assumptions. As a result, CBO's projected individual income tax revenues are lower than the Administration's projections (see Table III-4).

CBO's projection of higher wages and salaries and employment through 1987 also raises its estimates of social insurance tax receipts (about 90

TABLE III-4. ADMINISTRATION AND CBO ESTIMATES OF ADMINISTRATION BUDGET REVENUES, BY SOURCE
(By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
Administration Estimates						
Individual Income Taxes a/	295	332	368	406	453	498
Corporate Income Taxes	67	77	88	98	104	108
Social Insurance Taxes and Contributions a/	237	267	294	319	356	388
Excise Taxes						
Windfall profit taxes	9	8	7	6	6	6
Other taxes a/	29	30	27	27	28	29
Other	33	31	31	31	31	32
Total	670	745	815	888	978	1,060
Percent of Administration GNP	18.8	19.2	19.3	19.3	19.7	19.8
CBO Estimates						
Individual Income Taxes	294	334	368	403	447	489
Corporate Income Taxes	63	66	73	84	90	92
Social Insurance Taxes and Contributions	237	270	299	323	359	388
Excise Taxes						
Windfall profit taxes	8	7	5	4	4	4
Other taxes a/	29	31	28	28	29	30
Other	33	34	34	35	36	37
Total	665	741	807	878	964	1,039
Percent of CBO GNP	18.7	19.0	19.0	19.0	19.3	19.3

SOURCES: Budget of the United States Government for Fiscal Year 1985 and Congressional Budget Office.

NOTE: Details may not total because of rounding.

a. The Administration's budget estimates, as shown in the proposed budget, include a reduction in individual income taxes and an increase in social insurance taxes to reflect the general revenue transfer to the Social Security trust funds for the (partial) taxation of Social Security benefits. The estimates shown here exclude this transfer.

percent of which are Social Security taxes) above the Administration's through 1988. By 1989, the effects of CBO's lower projected wages and salaries and employment for 1988 and 1989 cause the CBO estimates of social insurance taxes to fall below the Administration's projections.

By itself, the lower CBO oil price projections reduce CBO's estimates of windfall profit tax receipts below the Administration's estimates throughout the five-year period. The largest remaining economic reestimate is attributable to CBO's projection of higher interest rates. Higher rates raise CBO's estimates of Federal Reserve payments to the Treasury above the Administration's by amounts that grow to $6 billion by 1989.

Technical Reestimates

Technical reestimates also lower CBO's revenue estimates relative to the Administration's in each year. Altogether, the effects of these factors are about twice as large as those ascribed to economic reestimates. Some technical differences are attributable in part to factors that might be properly considered to be economic, such as oil production or the growth of personal income across the income tax brackets.

The largest technical reestimates are those for the predominant single revenue source--individual income taxes. These reestimates, which account for roughly two-thirds of total technical reestimates, reduce the CBO revenue estimates relative to the Administration's in each year. On the basis of the Administration's assumed rates of real growth and inflation, CBO estimates that the overall tax rate applied to taxable personal income should be several tenths of a percent lower than the Administration's--a minor difference that accounts for most of the technical reestimate.

Technical reestimates of corporate income taxes, which place the CBO revenue projections below the Administration's in some years and raise them above in others, can be attributed in part to two differing assumptions: those concerning state business taxes, and those reflecting the amount of total profits accruing from the foreign operations of U.S. corporations. Almost all of the technical reestimates of social insurance taxes, which raise CBO revenue projections relative to the Administration's beyond 1985, are found in unemployment insurance (UI) tax estimates. The tapering-off in the growth of Administration UI tax projections is difficult to explain on the basis of economic projections and past program experience.

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CHAPTER IV. THE ADMINISTRATION'S DEFENSE BUDGET

The Administration's fiscal year 1985 budget proposes substantial real growth in defense spending over the next five years. Appropriation requests for national defense programs rise from $314 billion in 1985 to $456 billion in 1989, for a five-year total of over $1.9 trillion. Combining the Administration's dollar requests with CBO's assumptions about future inflation implies average annual real growth of 5.1 percent. As a consequence, defense spending would grow relative to the size of the economy, regaining the levels of the early 1970s.

The Administration's current defense budget plan is similar to the one proposed last year, although funding levels are somewhat lower. Budget authority is $16 billion less for 1985 than for 1984 and $42 billion less over the 1985-1988 period, mainly because the Administration's plan cuts previously planned purchases of ships, missiles, and aircraft.

The Administration's 1985 defense budget is higher, however, than the targets set by the Congress in its First Concurrent Resolution on the Budget for Fiscal Year 1984. The President's latest defense budget exceeds the budget resolution targets for 1985 by $17 billion in budget authority and $10 billion in outlays. Compared to CBO's national defense baseline projections for 1985-1989, which are based on the 1984 Congressional budget resolution, the Administration's latest defense budget is higher by over $80 billion in both budget authority and outlays. If inflation grows at the levels projected by CBO, which are higher than those assumed by the Administration, the President's latest defense budget could be underpriced by nearly $100 billion over the 1985-1989 period.

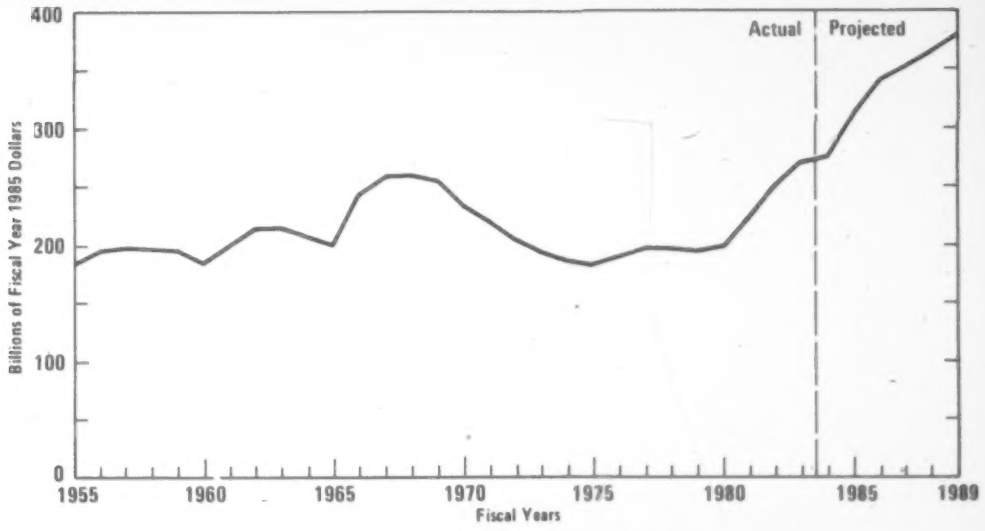
In contrast with recent experience, the real costs of defense weapons purchases in the 1985 budget are projected to decline significantly from the previous year. CBO analysis shows that expected declines in unit costs for weapon systems has lowered the 1985 budget by about $2.4 billion from the level projected a year ago. This anticipated decline in real costs may be the result of recent revisions in defense procurement policies.

DEFENSE FUNDING LEVELS

The President's budget proposes $314 billion in budget authority and $273 billion in outlays for the national defense function in 1985. This is an increase of $50 billion in budget authority and $38 billion in outlays from

Figure IV-1.

Budget Authority for National Defense (In Constant 1985 Dollars)



SOURCE: CBO calculations based on data from the Department of Defense.

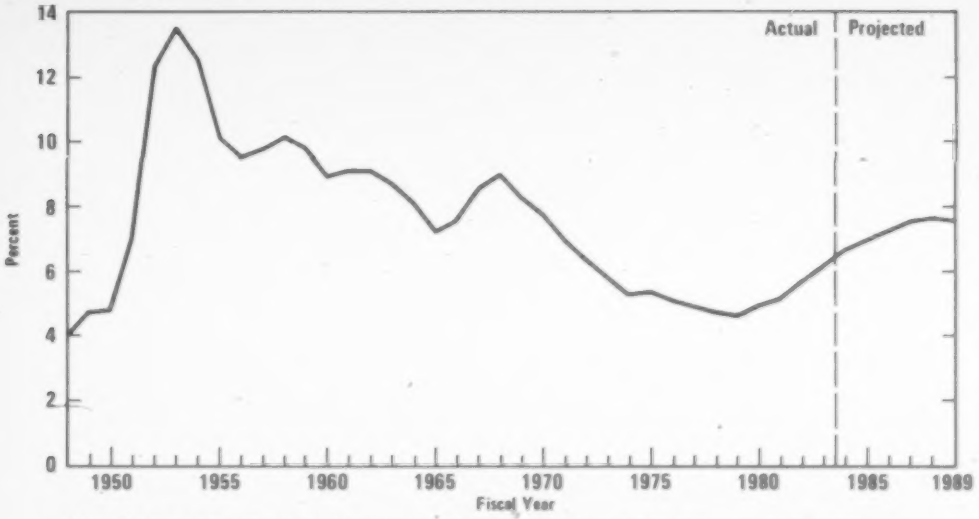
currently estimated levels for 1984. After adjusting for projected inflation, these increases would represent real growth of 12 percent in budget authority and 10.0 percent in outlays. The 12 percent real growth in budget authority would be as large as the increases provided in 1981 and 1982, and substantially larger than the 3.1 percent real increase provided in 1984.

Defense appropriations would continue to increase during each of the next four years, although at a decreasing rate. Total budget authority for national defense under the Administration's plan would rise to $359 billion in 1986 and to $456 billion by 1989. As shown in Table IV-1, the projected annual growth in defense spending authority slows from about 19 percent in 1985 and 14 percent in 1986 to a little over 8 percent annually in 1987-1989 in current dollar terms. In real terms, after adjusting for inflation, total budget authority is projected to grow by an average of 5.1 percent annually over the entire 1985-1989 period, but by only 2 percent annually over 1987-1989, according to Administration estimates.

Figure IV-1 portrays the real growth in national defense budget authority (in constant 1985 dollars) for 1985-1989. The projected levels of budget authority in real terms for 1985-1989 would be 39 percent above the

Figure IV-2.

National Defense Outlays as a Percent of GNP



SOURCES: For historical data, Department of Defense; for projections, Congressional Budget Office

amount appropriated by the Congress for the previous five years (1980-1984), and 37 percent above the levels provided during the Vietnam War (1966-1970).

Defense outlays also would grow substantially during the next five-years, rising from an estimated $235 billion in 1984 to $419 billion in 1989, an increase of 78 percent. The average annual nominal growth for the five-year period would be 12 percent, but the year-to-year growth would decline steadily from 17 percent in 1985 to 8 percent by 1989. In real terms, annual growth in defense outlays would average 5.8 percent for the five-year period. Like budget authority, however, the annual real growth rate in outlays would decline steadily from 10.0 percent in 1985 to only 2.1 percent in 1989 under the Administration's latest defense plan (see Table IV-1).

Relative to the total economy, defense outlays under the Administration's proposals would increase from 6.6 percent in 1984 to 7.8 percent in 1989. Figure IV-2 shows the post-World War II trend for defense outlays as a percentage of gross national product (GNP). Over the 1985-1989 period, defense outlays would average 7.5 percent of GNP, compared to 6.1 percent

TABLE IV-1. NATIONAL DEFENSE FUNDING LEVELS AS ESTIMATED BY CBO
(By fiscal year)

Funding Levels	1984	1985	1986	1987	1988	1989
			Budget Authority			
Administration 1985 Budget Proposals (in billions of dollars)	264	314	359	389	422	456
Nominal growth (percent change, year-to-year)	7.6	18.6	14.5	8.4	8.4	8.3
Real Growth (percent change, year-to-year)	3.1	12.0	7.7	2.0	2.1	2.1
CBO Baseline Projections a/ b/ (in billions of dollars)						
With 5% real annual growth in defense budget authority	264	297	329	367	409	455
With no real growth in defense budget authority	264	280	297	316	335	355
Administration 1984 Budget Proposals (in billions of dollars) c/	275	330	365	397	433	
			Outlays			
Administration 1985 Budget Proposals (in billions of dollars)	235	273	315	352	387	419
Nominal growth (percent change, year-to-year)	11.5	16.6	15.3	11.8	9.9	8.3
Real Growth (percent change, year-to-year)	7.5	10.0	8.2	5.2	3.7	2.1
CBO Baseline Projections a/ b/ (in billions of dollars)						
With 5% real annual growth in defense budget authority	235	263	295	329	367	408
With no real growth in defense budget authority	235	262	283	301	321	338
Administration 1984 Budget Proposals (in billions of dollars) c/	242	285	323	354	386	

SOURCE: Office of Management and Budget, with real growth based on CBO economic assumptions.

a. Includes revisions to previously published CBO baseline projections for 1985-1989. The CBO baseline is an extrapolation of the 1984 budget resolution.

b. The CBO baseline projections shown in this table have been revised from those published in the recent CBO annual report to Congress to reflect the mix of purchases in the Administration's latest budget plan, and to reflect the historical relationship between inflation for defense purchases and general inflation projected by CBO for the 1986-1989 period.

c. Administration's budget proposals contained in the Mid-Session Review of the 1984 Budget which OMB uses as the base for their current services estimates.

for the preceding five years. This amount is substantially lower, however, than the 8.5 percent average during the Vietnam War and the 10 percent average for the several years following the Korean War.

Comparison with CBO Defense Baseline Projections

The Administration's defense proposals are significantly above the CBO baseline projections for 1985-1989. Because the Administration requests such large increases in 1985 and 1986, their budget contains $90 billion more budget authority over the five-year period than if a constant 5 percent real increase occurred each year. In contrast, the CBO defense baseline is an extrapolation of the 1984 budget resolution, and shows annual real increases of about 5 percent in budget authority. 1/ For 1985 and 1986, baseline budget authority for national defense programs is the actual dollar amounts specified in the 1984 budget resolution. For 1987-1989, it is CBO's estimates of the amounts required to achieve real increases of 5 percent per year.

The Administration's budget and the CBO baseline show one way of achieving 5 percent annual real growth--with various growth rates in each year which produce a 5 percent average over the projection period. In the Administration's budget, the rapid increases in 1985 and 1986 yield much more budget authority over five years. A second approach would apply a constant 5 percent growth rate in each year and result in cumulatively less budget authority over the five-year period than either the Administration budget or the CBO baseline.

CBO has also calculated an alternative baseline for defense programs that is comparable to the baseline projections for nondefense discretionary spending. Under this alternative baseline, defense budget authority would be increased just enough to keep pace with inflation in the defense sector; there would be no real growth.

The Administration's latest defense budget plan exceeds the CBO baseline projection with 5 percent real annual growth by $17 billion in defense budget authority in 1985, and by $83 billion for the five-year period. Compared to a baseline with no real growth in defense budget authority, the

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1. The CBO baseline projections shown in Table IV-1 have been revised from those published in other recent CBO reports to reflect the mix of purchases in the Administration's latest budget plan, and to reflect the historical relationship between inflation for defense purchases and general inflation projected by CBO for the 1986-1989 period.

Administration's latest budget plan is $34 billion larger in 1985 and $356 billion more over the 1985-1989 period (see Table IV-1).

The differences between the CBO defense baseline outlay projections and CBO's estimates of outlays that would result from the Administration's budget authority proposals parallel those for budget authority. Compared to the CBO baseline projections with 5 percent real growth in defense budget authority, the Administrations defense outlays would be $10 billion, higher in 1985 and $84 billion higher over the entire five-year projection period. Relative to a zero growth baseline, outlays under the Administration's proposals would be $11 billion larger in 1985 and $241 billion higher over the 1985-1989 period.

Compared to last year's budget proposals, which OMB uses as its current services baseline for national defense, the Administration's latest defense plan shows somewhat lower budget authority and outlays for 1985-1988. Budget authority is $16 billion less for 1985 and $42 billion lower for the four-year period. The decreases primarily stem from reductions in the quantities of ships, missiles, and aircraft to be purchased. While inflation for defense purchases, including fuel purchases, is now projected at lower levels for 1984 and 1985 than was estimated a year ago, the Administration's defense inflation projections for 1985-1989 may prove to be overly optimistic. If this should be the case--a possibility that is examined in more detail later in this chapter--the Administration's latest defense plan would be underpriced.

Composition of the Administration's Defense Plan

Table IV-2 displays the composition of the Administration's defense budget as estimated by CBO. Over the five-year period, procurement accounts for the largest portion of the national defense budget, amounting to $679 billion, or 35 percent of total budget authority. The next largest component is defense operations, which receives $513 billion, or 26 percent of total defense spending authority. Military personnel, including accrued costs for retirement pay, takes another $412 billion, or 21 percent of total defense authority. Military research and development programs add $202 billion over 1985-1989, and military construction, family housing, and other national defense activities accounts for $133 billion.

Short-term changes planned for U.S. strategic nuclear forces, tactical air forces, and general purpose army and naval forces in 1985 are shown in Table IV-3. The major strategic force change is the retirement of eight Titan II intercontinental ballistic missile (ICBM) launchers, which is offset by the delivery of one Trident submarine. Tactical air forces are scheduled

TABLE IV-2. THE ADMINSTRATION DEFENSE BUDGET AS ESTIMATED BY CBO (By fiscal year, in billion of dollars)

Component	1984	1985	1986	1987	1988	1989
			Budget Authority			
Military Personnel	65.1	70.3	77.0	82.8	88.4	93.5
Operations and Maintenance	70.9	81.5	92.7	103.8	113.1	122.3
Procurement	85.2	107.9	126.0	137.0	147.1	161.5
Research, Development, Test and Evaluation	26.9	34.0	37.9	38.6	44.0	47.5
Other	9.2	11.6	16.1	17.0	18.9	21.3
Subtotal, DoD	257.3	305.3	349.7	379.2	411.5	446.1
Other National Defense	7.2	8.4	9.3	9.9	10.1	10.4
Total	264.5	313.7	359.0	389.1	421.6	456.4
			Outlays			
Military Personnel	64.6	69.5	76.3	82.1	87.7	92.8
Operations and Maintenance	68.6	78.1	89.2	99.9	109.5	118.7
Procurement	64.1	79.8	94.7	109.7	123.1	134.4
Research, Development, Test and Evaluation	24.0	29.7	34.9	37.4	41.1	45.1
Other	6.6	8.6	11.3	13.9	16.0	18.1
Subtotal, DoD	227.9	265.7	306.5	343.1	377.5	409.1
Other National Defense	6.7	7.7	8.8	9.4	9.9	10.3
Total	234.6	273.5	315.3	352.5	387.4	419.3

SOURCE: Congressional Budget Office.

TABLE IV-3. SUMMARY OF MAJOR U.S. FORCES AND MANPOWER FOR FISCAL YEARS 1983-1985

	1983	1984	1985
Active Forces (in units)			
Strategic bomber aircraft	297	297	297
Land-based intercontinental ballistic missiles	1,042	1,031	1,023
Sea-based intercontinental ballistic missiles	568	616	640
Army and Marine Corps divisions	19	19	20
Naval battle forces	504	513	532
Tactical air squadrons	162	165	168
Manpower (personnel in thousands)			
Active duty end strength	2,123	2,136	2,166
Civilian end strength	1,064	1,078	1,085

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

to increase by three squadrons--two for the Navy and one for the Air Force. The Army plans to activate a new light division. For naval forces, a net increase of nineteen battle force ships is planned for the active fleet in 1985.

In the longer term, major planned increases in force structure are designed to meet the Administration's goal of expanding Navy resources to over 600 ships by the early 1990s. The Air Force is also projected to expand from its present level of about 37 tactical wing equivalents to about 40 wing equivalents by 1989. The Administration's five-year plan for land forces includes continued force modernization through the acquisition of heavy and light armored vehicles as well as attack and assault-support helicopters, plus the addition of a seventeenth Army division.

Possible Underpricing for Inflation

In addition to the fact that the President has requested significant increases in national defense funding, there is some risk that the Administration may have underestimated the future costs of inflation in its projec-

tions. The defense budget is uniquely sensitive to inflation because so many of the items funded each year in annual appropriations take many years to produce. For example, a ship ordered in 1985 will result in outlays over the next five years or more. Thus, the 1985 budget must anticipate future prices at least through 1989, when the last funds for many currently ordered weapons systems will be spent. Higher than anticipated inflation could either necessitate a reduction in planned defense purchases to stay within appropriated funding, or require additional Congressional funding to complete the Administration's plans for weapons procurement and other purchases.

CBO predicts higher inflation for defense purchases than the Administration does for two reasons. First, CBO expects higher economy-wide inflation as measured by the GNP deflator. Second, CBO expects a greater difference between general price escalation rates and more specific rates relevant to defense purchases. Table IV-4 shows a comparison of CBO and Administration assumptions for price growth in the general economy, defense fuel purchases, and nonpay defense purchases in general.

In addition to the difference in general economic inflation trends, CBO anticipates faster weapons price growth than does the Administration over the next five years. 2/ The average percentage difference between Administration inflation rates for defense purchases and for the GNP deflator is one-sixth of the average difference over the past five years. In the CBO baseline projections for fiscal years 1985 to 1989, the spread between the GNP and the defense purchases deflators is about equal to the average differential (excluding fuel) during the past five years.

CBO anticipates price growth in DoD procurement to continue to outpace GNP price growth, especially after 1985. As orders for the major weapons systems enter their production stages, capacity in defense industries may be strained, and bottlenecks for isolated parts and raw materials could not only delay completion of the weapons but also drive up their prices as well. 3/ The impact of increasing procurement outlays will not affect all defense industries equally, however. The shipbuilding industry, for example, appears to have ample resources and capacity to handle the new defense

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2. For a comparison of the general economic forecasts of the CBO and the Administration, see Chapter II of this report.

3. See Congressional Budget Office, Defense Spending and the Economy (February 1983); and U.S. Department of Commerce, Bureau of Industrial Economics, Sectoral Implications of Defense Expenditures (August 1982).

TABLE IV-4. COMPARISON OF CBO AND ADMINISTRATION INFLATION PROJECTIONS (By fiscal year, in percents)

Deflator	1984	1985	1986	1987	1988	1989
GNP Deflator						
CBO	4.4	5.2	5.0	4.8	4.5	4.4
Administration	4.3	4.9	4.6	4.3	4.0	3.7
DoD Fuel Purchases Outlay Deflator						
CBO	-1.1	1.5	1.5	2.7	4.6	4.3
Administration	-2.5	0.5	0.5	3.2	4.2	3.7
Total Defense Purchases Outlay Deflator						
CBO	3.8	6.8	6.7	6.5	6.2	6.1
Administration	4.2	5.2	4.9	4.7	4.4	4.0

SOURCES: Congressional Budget Office, Department of Defense, and Office of Management and Budget, January 1984.

orders. There is more uncertainty about the existence of sufficient capacity in the aerospace, instruments and controls, and forgings and castings industries. Although no problems are anticipated in the next year, the projected increase in DoD outlays might strain the future ability of these producers to meet the increased demand without price growth.

Unlike procurement, price growth for operations and maintenance (O&M) purchases historically has not strayed too much above or below growth in the GNP deflator, an index often used to measure the general level of inflation in the economy. So any differences between CBO and the Administration for projected costs in O&M are probably attributable more to the difference in general economic forecasts, which include energy costs, than to conditions in defense-intensive industries.

Because there is often a long lag between the obligation of defense funds and the actual production of the defense goods, with attendant outlays, CBO computes different inflation rates for budget authority and outlays. For those procurement accounts whose budget authority will result

TABLE IV-5. CBO INFLATION PROJECTIONS FOR NATIONAL DEFENSE (By fiscal year, in percents) a/

	1985	1986	1987	1988	1989
Budget Authority					
Pay and benefits	3.5-5.5	5.8	5.6	5.5	5.3
Purchases	6.7	6.5	6.5	6.2	6.1
Composite	5.9	6.3	6.3	6.1	6.0
Outlays					
Pay and benefits	3.5-5.5	5.8	5.6	5.5	5.3
Purchases	6.8	6.7	6.5	6.2	6.1
Composite	6.0	6.5	6.3	6.0	6.0

SOURCE: Compiled by CBO from data supplied by the Department of Defense, and CBO.

a. The deflators used in this table differ from those in the CBO report Baseline Budget Projections for Fiscal Years 1985-1989 (February 1984), based on the pay raises and the mix of purchases in the Administration's 1985 budget submission and reestimates of the underlying indexes.

in outlays over many years, the inflation rate for budget authority reflects projected changes in prices over the period during which the budget authority will be spent. The outlay inflation rate, on the other hand, reflects only price changes for spending in the current year. Table IV-5 shows CBO's budget authority and outlay inflation rates for the two main components of the defense budget--pay and purchases.

Using CBO's inflation estimates for defense, the total amount of budget authority needed in 1985 would be $5 billion more than the President requested to fund the Administration's defense program (see Table IV-6). Over the 1985-1989 period, a total of $94.4 billion would need to be added to the President's February budget projections in order to carry out the Administration's program. For procurement accounts, this would result in a need for additional budget authority of $4.7 billion in 1985 and a total of $72.4 billion over the five-year period. For 1985, the required addition would be partially offset by decreases resulting from lower inflation estimates than those used by the Administration in certain other accounts.

TABLE IV-6. AMOUNT BY WHICH ADMINISTRATION'S DEFENSE PROGRAM MAY BE UNDERPRICED BECAUSE OF TOO LOW INFLATION ESTIMATES (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Five-Year Total
O&M						
Budget Authority	0.6	1.5	2.8	4.0	5.6	14.5
Outlays	0.4	1.2	2.4	3.6	5.1	12.7
Procurement Budget						
Budget Authority	4.7	8.8	13.6	19.1	26.1	72.4
Outlays	1.2	3.2	6.2	10.2	15.0	35.8
All Other Budget						
Budget Authority	-0.3	0.4	1.2	2.4	3.7	7.4
Outlays	-0.4	0.1	0.8	1.7	2.9	5.1
Total						
Budget Authority	5.0	10.7	17.6	25.5	35.4	94.4
Outlays	1.2	4.5	9.4	15.5	23.0	53.5

SOURCE: Compiled by CBO from data supplied by the Department of Defense, and CBO.

Potential Reductions

Much of the current debate about the Administration's defense budget is motivated by efforts to reduce projected deficits. It is important to understand that funds for some defense programs are appropriated in one year, but are spent over a number of years. Thus, a decision to cancel some investment programs in the 1985 budget would produce only small outlay savings in 1985 compared with the changes in the total amount of funds requested. The following breakdown of the source of defense outlays in the 1985 budget helps to illustrate this problem.

- 36 percent ($97 billion) of national defense outlays for 1985 result from budget authority provided in 1984 (including proposed supplementals) and earlier years.

- 33 percent ($90 billion) of 1985 outlays relate to proposed 1985 budget authority for pay and benefits for military and civilian defense personnel.

- 17 percent ($48 billion) of 1985 outlays are for operating and support costs, including training, logistics, and various personnel support activities that sustain current force readiness.

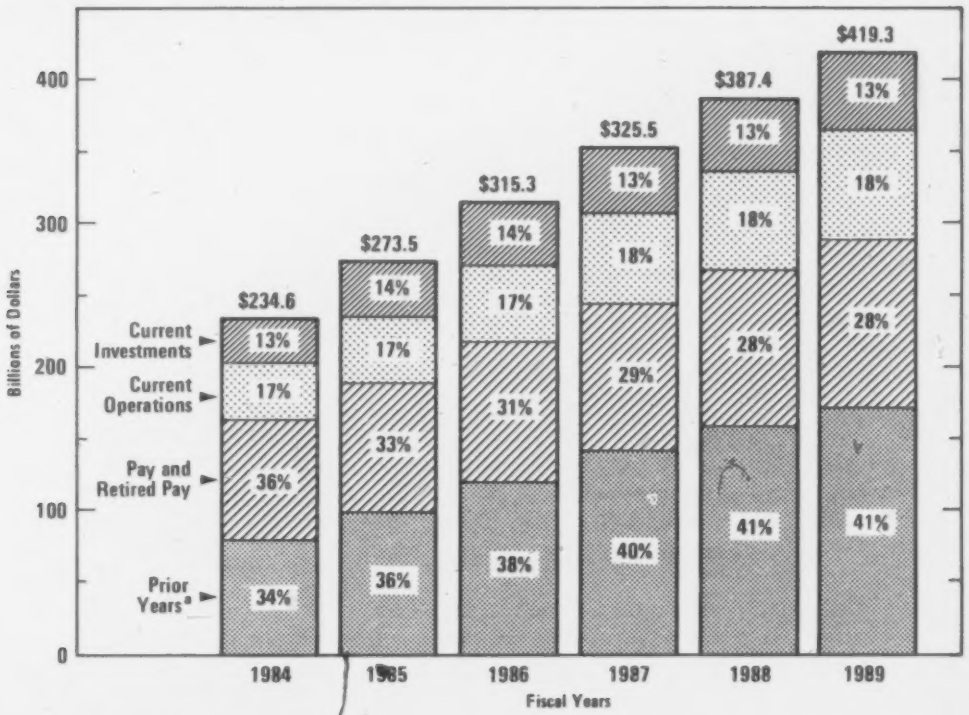
- 14 percent ($39 billion) of 1985 outlays stem from 1985 budget authority for modernization through new weapons procurement, research and development, and military construction.

Reducing the $97 billion of 1985 outlays from prior-year budget authority would require cancellation, delay, or termination of programs already approved, often already under contract, and, in some cases, partially manufactured. Substantial financial penalties could result if the government canceled orders for partially built weapons or if the rate of production was substantially slowed. The preponderance of programs in this category represent fully funded orders for major weapons systems and construction that expend appropriations over several years. These characteristics mean that 1985 outlay savings would be only a small portion of the ultimate outlay reductions from cutting such programs.

Similar problems affect other categories. For example, if none of the $107.9 billion in budget authority requested for weapons systems procurement was appropriated in 1985, outlays in that year would decline by less than $16 billion, because so much of the budget authority would be spent after 1985 when most production would occur. Thus, to achieve a high proportion of 1985 outlay savings from the Administration's 1985 request would require cuts in readiness items rather than investments to improve future modernization. Immediate outlay effects could be obtained by trimming purchases with relatively short order-to-delivery times, such as fuel, spare parts, and depot maintenance--all of which would affect current readiness--or by cutting personnel levels, which would reduce current force levels.

Figure IV-3 shows that the basic structure of defense outlays does not change much between 1984 and 1989 except that the share of outlays from prior years' funding increases each year. The growing share of outlays from prior years means that the Congress has less and less control over outlays in each budget year under consideration. Given this unfavorable trend and the difficulty in achieving immediate outlay savings, clearly reducing the deficit by reducing defense spending would require a multiyear approach. For 1985, the Administration has requested $223 billion in budget authority for nonpay purchases; the outlays from this budget authority would total $86 billion in

Figure IV-3.
Composition of National Defense Outlays



SOURCE: Congressional Budget Office.

[a]Outlays from prior years' budget authority.

1985, $74 billion in 1986, $35 billion in 1987, and lesser amounts each year thereafter. So, in making decisions on these programs for 1985, Congress affects 1986 outlays almost as much as it affects 1985 outlays.

In order to illustrate some of the choices that the Congress has if it wishes to reduce the 1985 defense budget, Table IV-7 shows some options assuming fixed growth rates. While these options illustrate the outlay impact of various approaches to reducing the defense budget, they do not address a more difficult question that the Congress would face: which specific programs and systems should be cut to obtain reduced funding? One set of options can be found in Chapter II of the CBO report, Reducing the Deficit: Spending and Revenue Options (February 1984).

The next section of this chapter indicates which major accounts receive the real growth requested in the 1985 budget and serves as an introduction to subsequent sections describing the Administration's budget in more detail and comparing it to previous plans.

TABLE IV-7. COMPARISON OF THE CBO REESTIMATE OF THE ADMINISTRATION'S 1985 DEFENSE BUDGET WITH ALTERNATIVE BUDGET ASSUMPTIONS (By fiscal year, in billions of dollars)

Spending Level	1985	1986	1987	1988	1989	Cumulative Five-Year Savings
Administration's Request						
Budget Authority	314	359	389	422	456	
Outlays	273	315	352	387	419	
Savings Under Alternative Assumptions						
0 Percent Real Growth						
Budget Authority	34	62	73	86	101	356
Outlays	11	32	51	66	81	241
1 Percent Real Growth						
Budget Authority	31	56	64	73	83	306
Outlays	10	29	45	57	68	210
2 Percent Real Growth						
Budget Authority	28	50	54	59	64	255
Outlays	9	26	40	48	55	178
3 Percent Real Growth						
Budget Authority	26	44	44	44	44	202
Outlays	8	23	34	39	41	145
4 Percent Real Growth						
Budget Authority	23	38	34	29	24	148
Outlays	7	20	28	29	27	112
5 Percent Real Growth						
Budget Authority	20	31	23	14	3	92
Outlays	7	17	22	19	13	78

SOURCE: CBO and data supplied by the Department of Defense.

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GROWTH IN DEFENSE APPROPRIATION REQUEST FOR 1985

The Administration's request for defense appropriations for 1985 totals $313.7 billion, which is $49.2 billion more than its 1984 request. After adjusting for the costs of projected inflation, estimated to be $15.5 billion by CBO, this increase would provide real growth of $33.7 billion or 12 percent above 1984 levels. Although this increase is large by historical standards, it is roughly $16 billion less than the levels for defense appropriations for 1985 projected by the Administration a year ago.

One way to analyze the Administration's defense budget is to examine the sources of real growth in the budget. As shown in Table IV-8, the bulk of requested real growth in defense falls in the categories of procurement and of research, development, testing, and evaluation (RDT&E). This reflects a continuation of the Administration's emphasis on modernization of military equipment and expansion of forces. This section discusses the nature of requested real growth in defense more fully. Defense real growth from 1984 to 1985 is summarized by appropriation categories in Table IV-9.

Procurement Plans

Under the Administration's 1985 defense budget, procurement appropriations would increase by about $16 billion in real terms from 1984 to 1985.

TABLE IV-8. SOURCES OF GROWTH IN DEFENSE APPROPRIATIONS REQUEST FOR 1985 (In billions of dollars)

Category	Amount of Increase
Real Growth	
Procurement	16.0
Operations and Maintenance	7.3
Research, Development, Test and Evaluation	5.7
Other	4.7
Subtotal	33.7
Cost of Projected Inflation	15.5
Total	49.2

SOURCE: Compiled by CBO from data supplied by the Department of Defense and using CBO inflation assumptions.

TABLE IV-9. REAL GROWTH IN DEFENSE BUDGET AUTHORITY AND OUTLAYS, BY APPROPRIATION CATEGORIES (By fiscal year, in billions of dollars)

Category	1984 Request	1985 President's Budget Request	1985 Real Growth in Budget Authority a/ Billions of Dollars	1985 Real Growth in Budget Authority a/ Percents b/
Department of Defense				
Military				
Military personnel				
Budget authority	63.9 c/	67.8	2.1	4.2
Outlays	63.4	67.1	---	---
Operations & maintenance				
Budget authority	70.4	80.9	7.3	10.0
Outlays	68.1	77.5		
Procurement				
Budget authority	85.2	107.9	16.0	17.4
Outlays	64.1	79.8		
RDT&E				
Budget authority	26.9	34.0	5.7	20.1
Outlays	24.0	29.7	---	---
Military construction				
Budget authority	4.5	7.2	2.4	50.8
Outlays	4.0	4.7	---	---
Family housing				
Budget authority	2.7	3.2	0.3	12.2
Outlays	2.3	2.7		
Revolving funds				
Budget authority	2.5	1.8	-0.9	-33.7
Outlays	0.8	1.8	---	---
Other DoD				
Budget authority	1.2	2.5	d/	d/
Outlays	1.2	2.4	---	---
Total, DoD				
Budget authority	257.3	305.3	32.9	12.0
Outlays	227.9	265.7	---	---
Atomic Energy Defense Activities				
Budget authority	6.7	7.8	0.7	10.1
Outlays	6.1	7.2	---	---
Defense-Related Activities				
Budget authority	0.5	0.6	0.1	19.6
Outlays	0.5	0.5	---	---
Total				
Budget authority	264.5	313.7	33.7	12.0
Outlays	234.6	273.5	---	---

SOURCE: Compiled by CBO from data supplied by the Department of Defense and CBO.

a. Real growth computed using CBO's economic assumptions and the President's pay-raise assumptions.
b. Individual percentage calculations are not weighted and therefore are not additive.
c. These amounts include 1984 retirement accruals for comparability with 1985.
d. Since the amounts in this category include offsetting receipts and the allowance for 1985 pay raises, real growth computations are not meaningful.

Increases are proposed in the following areas: aircraft and missiles, including strategic systems such as the MX missile, B-1 bomber and tactical air-to-surface, surface-to-air, and surface-to-surface missiles; fighting vehicles; light armored vehicles; readiness and sustainability items, such as spare and repair parts and ammunition; modifications of existing equipment; and investment in communications, electronics, vehicles, and other support equipment.

Aircraft. Table IV-10 shows that aircraft purchases planned through 1986 would steadily increase above 1983 levels. The Administration proposes buying 147 more aircraft in 1985 than in 1984. Requests for AH-64 attack helicopters and other Army aircraft, such as transport helicopters and reconnaissance aircraft, increase by 46 aircraft, although 6 fewer UH-60 assault-support helicopters would be purchased. Except for increases in AV-8B attack aircraft and aircraft such as trainers and transports, requests for Navy and Marine Corps aircraft in 1985 are relatively unchanged from the levels funded for 1984. The most significant changes in the Air Force program are the projected increases for purchases of F-16, F-15, B-1B, and C-5 aircraft.

The Administration's plan for 1986 projects buying 208 more aircraft than in 1985. This proposed increase is about equally divided between the Navy and the Air Force. The plan would fund increased purchases of F/A-18, AV-8B and other aircraft such as trainers and transports for the Navy and Marine Corps. In 1986, the Air Force plans to increase the level of orders for F-16, F-15, B-1B, KC-10, C-5B and trainer aircraft. Army orders for CH-47 helicopters and RC-12 aircraft would decrease from the amount requested in 1985.

Missiles. The request for all strategic and theater nuclear missiles for 1985 is 194 missiles less than the number funded for 1984. As shown in Table IV-11, the Air Force requests fewer strategic and theater nuclear missiles overall than in 1984, but the Army and Navy plans to buy more of these missiles. The Army's request reflects increased procurement of Pershing II missiles. The Navy plans to buy more Tomahawk missiles in 1985 compared to 1984 but proposes to make no further new purchases of Trident I missiles in 1985. Projected changes include no further purchases of air-launched cruise missiles and increased purchases of MX missiles.

The Defense Department's procurement plan for unclassified purchases in 1986 is relatively unchanged from the plan for 1985, except for planned purchases of MX missiles.

The Administration's request for purchases of tactical missiles in 1985 includes the acquisition of four groups of missiles:

TABLE IV-10. AIRCRAFT ACQUISITION PLANS, BY SERVICE (By fiscal year, in units procured)

Aircraft Type	1983	1984	1985	1986
Army				
AH-64 helicopter	48	112	144	144
UH-60 helicopter	96	84	78	78
EH-60 helicopter	--	12	18	a/
Other aircraft	31	6	20	--
Subtotal	175	214	260	222
Navy/Marine Corps				
F/A-18 aircraft	84	84	84	102
F-14 aircraft	24	24	24	24
AV-8B aircraft	21	27	32	46
A-6E aircraft	8	6	6	--
EA-6B aircraft	6	8	6	6
CH-53E helicopter	11	11	10	14
SH-60B helicopter	27	21	18	18
Other aircraft	93	51	107 b/	198
Subtotal	274	232	287	408
Air Force				
F-16 aircraft	120	144	150	216
F-15 aircraft	39	36	48	60
B-1B aircraft	7	10	34	48
KC-10 aircraft	8	8	8	12
E-3A aircraft	2	--	--	--
C-5B aircraft	1	4	10	16
TR-1 aircraft	5	5	4	1
Other aircraft	15	18	17	43
Subtotal	197	225	271	396
Total	646	671	818	1,026

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

a. Excludes purchases that are classified.

b. Excludes tentative purchases of from 2 to 6 used C-9 aircraft.

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- Air-to-air missiles, which include Air Force and Navy versions of Sparrow and Sidewinder, the Navy Phoenix and Sidearm, and the Air Force advanced medium range air-to-air missile (AMRAAM).

- Air-to-surface missiles, which include Army and Navy purchases of Hellfire, and Air Force and Navy versions of Maverick and high-speed anti-radiation missiles (HARM), as well as purchases of Harpoon missiles for the Air Force.

TABLE IV-11. STRATEGIC AND THEATER NUCLEAR MISSILE ACQUISITION PLANS, BY SERVICE (By fiscal year, in units procured)

Missile Type	1983	1984	1985	1986
Army				
Pershing II	91	70	93	a/
Navy				
Trident I	62	52	--	--
Tomahawk	51	124	180	180
Subtotal	113	176	180	180
Air Force				
MX	--	21	40	48
Air-launched cruise missile	330	240	b/	b/
Ground-launched cruise missle	84	120	120	120
Subtotal	414	381	160	168
Total	618	627	433	348

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

a. Quantity classified.
b. Program terminated in favor of a classified radar evading version which is not included in this table.

- o Surface-to-air missiles, which include the Army Patriot and Chaparral, Navy Rolling Airframe missile (RAM), and Marine Hawk, as well as purchases of Stinger for the Army, Marines, and Air Force.

- o Surface-to-surface missiles, which include Army and Marine purchases of TOW anti-tank missiles (which can also be used as air-to-surface missiles), Navy purchases of Harpoon 4/ and Standard missiles, and Army purchases of rockets for the Multiple Launch Rocket System.

Table IV-12 shows that the number of tactical missiles would increase steadily from 1983 to 1986. The Administration requests 22,500 more tactical missiles in 1985 than were funded for 1984. About 64 percent of the proposed increase is in relatively inexpensive rockets for the Multiple Launch Rocket System. The Administration also requests more air-to-surface missiles, surface-to-air missiles, and surface-to-surface missiles in 1985, than in 1984, but would buy fewer air-to-air missiles.

Defense Department plans for 1986 propose a 39 percent increase, or about 37,000 more tactical missiles than the total plan for 1985. Again, about 60 percent of the proposed increase would be for purchases of rockets for the Multiple Launch Rocket System. DoD proposes to buy more of all missile types in 1986 than were requested for 1985.

Armored Vehicles. Armored combat vehicles include tanks, fighting vehicles, light armored personnel carriers, and ancillary armored recovery vehicles. The Administration's armored combat vehicle program emphasizes acquisition of two "families" of vehicles (see Table IV-13):

- o Heavy combat vehicles dedicated for use by Army forces in Europe committed to NATO; and

- o Light armored vehicles for both the Army and the Marine Corps to support the heavy combat vehicles committed to NATO and to strengthen the Rapid Deployment Force, primarily for deployment in the Middle East.

The major 1985 change for heavy combat vehicles is a reduction of 120 M-1 tanks from the level funded for 1984. Proposed quantities for the tank's companion fighting vehicles would increase in 1985 by 110, however. The budget proposes increased quantities of field artillery ammunition support

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4. Harpoon missiles can be air-launched as well as sub-surface launched.

TABLE IV-12. TACTICAL MISSILE ACQUISITION PLANS, BY TYPE AND SERVICE (By fiscal year, in units procured)

Missile Type	1983	1984	1985	1986
Air-to-Air Missiles				
Navy	1,228	1,310	2,650	3,630
Air Force	3,107	2,705	174	1,042
Subtotal	4,335	4,015	2,824	4,672
Air-to-Surface Missiles				
Army	3,971	4,651	6,026	6,576
Navy	250	785	2,031	3,783
Air Force	1,029	2,321	5,456	9,682
Subtotal	5,250	7,757	13,513	20,041
Surface-to-Air Missiles				
Army	1,293	1,645	2,945	7,582
Navy/Marine Corps	1,771	1,091	1,330	2,672
Air Force	--	60	156	--
Subtotal	3,064	2,796	4,431	10,254
Surface-to-Surface Missiles				
Army	35,640	54,000	68,472	90,000
Navy/Marine Corps	2,373	3,703	5,556	6,804
Subtotal	38,013	57,703	74,028	96,804
Total	50,662	72,271	94,796	131,771

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

vehicles for the Army and "off-the-shelf" light armored vehicles for the Marine Corps. Reduced purchases of light command post carriers and armored personnel carriers are also planned.

The plan for 1986 includes about 260 fewer armored vehicles than the total requested for 1985. It does include increases in fighting vehicles and medium recovery vehicles, but no planned purchases of light command post carriers, armored personnel carriers, or light armored vehicles.

TABLE IV-13. ARMORED COMBAT VEHICLE ACQUISITION PLANS, BY TYPE AND SERVICE (By fiscal year, in units procured)

Vehicle Type	1983	1984	1985	1986
Heavy Combat Vehicles				
Army				
M-1 tanks	855	840	720	720
Fighting vehicles	600	600	710	900
Subtotal	1,455	1,440	1,430	1,620
Light Armored Vehicles				
Army				
M-113 armored personnel carriers	520	125	50	--
Light command post carriers	--	250	167	--
Field artillery ammunition support vehicles	54	120	170	230
M-88A1 medium recovery vehicles	180	180	180	180
LAV-25 light armored vehicles	36	--	--	--
Subtotal	790	675	567	410
Marines				
Light armored vehicles	134	236	292	--
Total	2,379	2,351	2,289	2,030

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

Procurement of Readiness Related Items. Procurement programs devoted to readiness of military forces include spare and repair parts, support equipment, facilities, and munitions necessary to keep military forces ready for combat in peacetime and to sustain their operations once combat begins. In past years, funding for readiness has often been reduced to pay for procurement of aircraft, tanks, and ships. Both the Reagan and Carter Administrations, however, have been committed to raise funding for readiness.

As shown in Table IV-14, the proposed funding for readiness items in 1985 would increase by about $4.3 billion over the level funded for 1984. Similarly, the planned level for 1986 expenditures is about $2.7 billion higher than the 1985 total. In each year, proposed funding for spare parts, support equipment, and facilities would receive the larger share of the increase.

Ships. The Administration continues its ambitious shipbuilding and conversion program. As Table IV-15 shows, its plan calls for 142 ships to be constructed, converted, modified, or leased between 1985 and 1989. The proposed budget for shipbuilding and conversion increases from $11.4 billion in 1984 to $13.1 billion in 1985. The 1985 request for 29 ships reflects a net increase of seven ships over those funded in 1984. The Administration's funding request for major warships reflects the following increases above 1984 levels: one additional destroyer, reactivation of a battleship, one complete overhaul of an aircraft carrier, and one attack submarine. The 1985 request also reflects procurement of one less frigate and four fewer support ships than in 1984.

Research and Development (R&D)

The Administration's 1985 appropriations request for R&D is spread across nearly all defense elements, but is concentrated in advanced

TABLE IV-14. PROPOSED FUNDING FOR READINESS ITEMS (By fiscal year, in billions of 1985 dollars)

Readiness Category	1983	1984	1985	1986
Spare Parts, Support Equipment, and Facilities	13.7	15.4	18.6	20.1
Munitions a/	3.8	3.5	4.6	5.8
Total	17.5	18.9	23.2	25.9

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

a. Navy ammunition was included in ordinance support equipment and aviation support equipment in the budget documentation.

TABLE IV-15. ADMINISTRATION'S NAVY SHIPBUILDING PROGRAM FOR 1985-1989 (By fiscal year, in units procured)

Ship Type	Funded 1984	1985	1986	1987	1988	1989	1985-1989 Total
Trident Submarines	1	1	1	1	1	1	5
Other Major Warships a/	6	10	7	12	11	12	52
Amphibious Ships b/	2	2	3	3	6	6	20
Mine Warfare and Patrol Ships c/	5	4	8	5	4	4	25
Auxiliaries	8	12	10	5	6	7	40
Total b/ d/	22	29	29	26	28	30	142

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

a. Includes service life extension program for one conventional carrier in 1985 and 1987, but no nuclear carriers.
b. Total excludes Landing Craft Air Cushion (LCAC) ships--57 over the 1985-1989 period.
c. Includes frigates.
d. Includes planned reactivations and conversions.

technology and tactical programs. Advanced technology programs explore alternative designs before development of specific hardware or software systems. Major programs include Strategic Defense Initiatives--the so-called "star wars" program--very high speed integrated circuits, aircraft propulsion, ship propulsion, and aircraft avionics. Major levels of peacetime tactical research programs include a derivative of the F-15 or F-16 aircraft, a modernized version of the F-14, an advanced tactical fighter, as well as joint Army/Air Force programs for target acquisition and use of new missiles to strike targets behind enemy lines.

Operations and Maintenance

The proposed real increase of $7.3 billion in 1985 over 1984 for operations and maintenance (O&M) appropriations would support higher levels of

peacetime activity for aircraft flying time, naval operations at sea, and other activities. Among the military services, the Navy shows the largest gain in proposed funding. Much of this increase would be applied to depot maintenance and the support necessary to sustain a planned increase to annual ship operations of about fifty thousand hours at sea, or 3.5 percent more than proposed for 1984. The Air Force program would fund increases to space support programs, logistics programs, and operations support for over 200 thousand added aircraft flying hours--an increase of about 3.6 percent over the number funded in 1984. The increase in Army O&M appropriations primarily reflects the costs of continuing the Army modernization program and increases in battalion and individual training.

Military Personnel

The military personnel account contains $2.1 billion, or 4.2 percent, real growth in 1985. Most of this increase comes from the request for an additional 29,900 active and 52,200 selected reserve personnel. Included in this amount is $200 million for grade enrichment. 5/

Other Accounts

The $2.4 billion proposed real increase in military construction from 1984 to 1985, shown in Table IV-9, results partly from the continuation of the facilities modernization program begun in 1981. The 1985 program includes some support facilities for Pershing II and the ground-launched cruise missile that were deleted by Congress from the 1984 request. Military construction for other weapons systems, notably the Trident submarine, MX, B-1B and KC-10, also explains part of the increase.

Requests for atomic energy defense accounts are increased in 1985 over the levels funded for 1984 by $0.7 billion in real terms, or 10.1 percent using CBO's deflator. Other 1985 requests for DoD spending for military family housing, revolving funds, and defense related activities decline in real terms by about $0.5 billion from the 1984 plan.

Another way to analyze the current defense budget is to study the changes relative to the defense projections for 1985 that the Administration made last year. This analysis shows that the Administration has scaled

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5. Grade enrichment represents an increase in the average grade level from one year to the next. Grade enrichment builds upon itself year after year. This year's increased grade structure comes on top of a $122 million grade enrichment from last year.

down its defense program somewhat, primarily by reducing its plans for procurement and RDT&E. The next section examines these changes in the scope of the Administration's defense plans.

CHANGES FROM THE 1984-1988 DEFENSE PLAN FOR FISCAL YEAR 1985

The Administration's defense request for 1985 is significantly larger than its current estimates for 1984. Yet, it also is somewhat scaled down from the Administration's projection of defense appropriations for 1985-1988 that was submitted last year. For example, defense budget authority now is $16.6 billion less in 1985 and $41.6 billion less over the period. As shown in Table IV-16, the 1985 budget request reflects a reduction of $19.0 billion from previously proposed funding for procurement, military construction, operations and maintenance, pay, military personnel, family housing, and atomic energy defense activities. These reductions would be partially offset by proposed increases in research and development and other activities for a net decrease of $16.6 billion.

Undoubtedly the Administration's reduction in defense plans was partly a response to the reductions made by the Congress in the fiscal year 1984 budget. A portion of the reduction, however, reflects the fact that the Defense Department now projects lower pay-raise costs and lower unit costs for purchases of major weapons. These two considerations permit a reduction in projected costs of defense programs without reducing tangible goods or services devoted to defense. The vast majority of reductions, however, are achieved by slowing the growth of investment in new weapons and equipment.

This section provides a detailed discussion of the changes in the defense program as a result of the Administration's scaled-down plan. The section also examines the Defense Department's projections of reductions in unit costs of major weapons purchases.

Program Decreases

In the aggregate, requested budget authority for purchases of individual weapons systems in 1985 is $12.1 billion less than corresponding projections a year ago. Of this reduction, $2.4 billion reflects anticipated savings from lower unit procurement costs projected by DoD for major weapons purchases. The remainder reflects actual reductions in procurement plans. Unfortunately, the exact amount of these reductions cannot be identified by individual programs because the total appropriations projected for defense procurement by the Administration last year was $3.1 billion less than the sum of its projections of costs for individual

TABLE IV-16. ADMINISTRATION CHANGES TO 1985 DEFENSE BUDGET BETWEEN JANUARY 1983 AND FEBRUARY 1984 (Budget authority in billions of dollars)

Administration Proposals	
1985 budget (February 1984)	313.4
1984 budget (January 1983)	330.0
Total net change	-16.6
Net Decreases	
Procurement	-12.1
Construction of facilities	-2.7
Operations and maintenance	-2.2
Pay raises	-1.1
Military personnel	-0.4
Family housing	-0.3
Atomic energy defense activities	-0.2
Subtotal, decreases	-19.0
Net Increases	
Research and development	1.8
Other increases	0.6
Subtotal, increases	2.4
Total net change	-16.6

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

programs. Because of this anomaly, the following subsections identify only the gross amount of reductions without benefit of the allocation of the undistributed reduction of $3.1 billion. Oddly, the opposite of this anomaly has surfaced in the current defense budget, because the aggregate procurement costs now projected by the Administration for 1986 is roughly $2 billion more than the sum of the individual procurement programs detailed in the budget.

Aircraft. As shown in Table IV-17, the Administration requests 82 fewer aircraft purchases than previously planned for 1985, thereby saving

TABLE IV-17. ADMINISTRATION CHANGES FOR AIRCRAFT PROCUREMENT PLANS BETWEEN JANUARY 1983 AND FEBRUARY 1984 (By fiscal year, in units procured)

Aircraft Type	1985	1986
Combat Aircraft		
Navy/Marine Corps		
F/A-18	-8	-4
F-14	--	-6
A-6E	--	-6
AV-8B	-16	-14
Air Force		
F-15	-24	-36
F-16	30	36
Other Aircraft	-64	-19
Total	-82	-49

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

about $4.6 billion in budget authority for 1985. This reduction includes 24 fewer combat aircraft for the Navy.

The Navy plans to purchase 287 aircraft in 1985, some of which are for the Marine Corps. Navy procurement planning data, however, indicate that at least 324 aircraft should be procured annually to maintain both the strength and the present average age of current carrier air wings. 6/ Thus, if procurement quantities continued at this rate, there would not be enough aircraft to sustain the current 13 carrier air wings or to begin the proposed increase to 14 carrier air wings by 1987.

In 1985, the Air Force plans to procure 198 fighter aircraft, which is six more than the 1984 plan. Air Force procurement planning data indicate

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6. Each carrier air wing typically contains about 86 aircraft.

that 265 aircraft should be purchased annually to sustain both the size and the average age of the 40.5 tactical and air defense wing equivalents now planned for 1985. 7/ If the procurement quantities continued at the 1985 requested rate, there would not be enough aircraft to sustain the existing air wings or to begin the Air Force's proposed increase to 40 air wings by 1989. The Air Force objective of 40 air wings by 1989 has slipped from its previous goal of 41 wings by 1988.

Missiles. The Administration has reduced its planned procurement of missiles thereby saving roughly $3 billion in budget authority for 1985 relative to last year's plan. As shown in Table IV-18, this year's defense plan reduces planned purchases of the Tomahawk strategic missiles for 1985 and 1986. The 1985 plan proposes buying nearly 1,700 fewer tactical missiles in 1985 compared with last year. Procurement of many individual systems would be reduced, but the largest planned decreases are for the IIR Maverick, missile-launched laser-guided bombs, Stinger, Standard missiles, and Patriot systems. The Administration's new plan for the Air Force proposes over 1,000 fewer missile purchases for 1986 compared with the previous projection for the same year. Reductions in IIR Mavericks and missile-launched laser-guided bombs would be partially offset by proposed increases in purchases of Navy tactical missiles, such as Sparrow, Laser Maverick, TOW, HARM, and Hellfire missiles.

Ships. The current shipbuilding plan for 1985 proposes two more newly constructed ships than were proposed in last year's plan. Both are support ships costing less than $300 million. Despite this increase, the Administration projects the shipbuilding account to be $1.6 billion lower than last year's plan for 1985, primarly as a result of estimated lower costs per ships. For 1985-1988, the latest shipbuilding plan cuts 11 from the number of new construction ships to be built, including four major warships. Table IV-19 shows this reduction by category of ship.

Last year's shipbuilding plan was presented as the level of construction needed to meet the goal of a modern navy of 600-plus ships with 15 carrier battle groups by 1990. This goal could still be achieved with the revised shipbuilding plan. The pace of modernization would be much slower, however, particularly for major warships.

Armored Vehicles. The Administration's proposed 1985 reduction in procurement of weapons and tracked combat vehicles would save about $500 million from last year's plan. Proposed purchases of the M-1 tank's companion fighting vehicle have been reduced by 120 and 180 vehicles in

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7. Each wing typically contains three squadrons of 24 aircraft each.

TABLE IV-18. ADMINISTRATION CHANGES FOR MISSILE PROCUREMENT PLANS BETWEEN JANUARY 1983 AND FEBRUARY 1984 (By fiscal year, in units procured)

Missile Type	1985	1986
Strategic a/		
Navy		
Tomahawk	-173	-248
Air Force		
MX	3	--
Subtotal, Strategic	-170	-248
Tactical		
Army	-480	-943
Navy/Marine Corps	-12	1,864
Air Force	-1,197	-1,018
Subtotal, Tactical	-1,689	-97
Total	-1,859	-345

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

a. Excludes purchases of Pershing II missiles because quantities are classified in 1986.

1985 and 1986, respectively. In addition, previous plans to purchase 281 light armored vehicles in 1985 and 256 in 1986 were cancelled in this year's budget.

Decrease in Projected Unit Costs of Weapons. A significant change in the 1985 budget is DoD's projection of decreases in the unit costs of major weapons systems. CBO's preliminary analysis of 74 major systems in the Administration's budget indicates that unit prices have decreased $2.4 billion from previous projected costs for 1985.

Defense purchases have experienced significant cost growth in recent years. Actual inflation frequently has been higher than expected. In addition, unbudgeted program changes (such as new specifications or revised production schedules) and underestimation of required resources, such as

TABLE IV-19. ADMINISTRATION CHANGES BETWEEN JANUARY 1983 AND FEBRUARY 1984 FOR NEW CONSTRUCTION IN NAVY SHIPBUILDING PLAN FOR FISCAL YEARS 1985-1988 (In units procured)

Ship Type	1985	1985-1988
Nuclear Carriers	--	-1
Destroyers	--	
Attack Submarines	--	-2
Amphibious Assault	--	-1
Mine Warfare	--	1
Support	2	-7
Total	2	-11

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

manufacturing hours, material, and labor costs, has resulted in unit cost growth. DoD has dubbed these latter phenomena collectively "real cost growth"--that is, the portion of growth not related to general price increases.

After recognizing the cost growth problem in major weapons systems, the Administration instituted a number of acquisition initiatives to restrain real cost growth. Sufficient information does not yet exist to evaluate fully the success of these initiatives. The data presented below, however, suggest that real cost growth declined for many major weapons systems during 1983, if DoD's unit cost projections prove to be accurate. As explained earlier, the sum of the DoD estimates of costs for individual systems last year was $3.1 billion more than the total procurement budget for 1985. Because of this anomaly, the $2.4 billion reduction from lower unit costs can only be a very crude calculation without the benefit of the allocation of the $3.1 billion to specific programs. Justification material included with the 1985 budget does not provide any explanation. CBO will further examine this cost-growth issue when it receives the latest Selected Acquisition Reports, which are due in March.

Table IV-20 provides cost-growth data for 74 major weapons systems by comparing 1985 unit costs as initially projected by the Administration in January 1983 against estimates contained in the current 1985 budget. The

TABLE IV-20. ADMINISTRATION CHANGES IN 1985 MAJOR WEAPONS SYSTEMS COSTS BETWEEN JANUARY 1983 AND FEBRUARY 1984 (In millions of dollars and percents)

Weapon System	Procurement Unit Cost January 1983	Procurement Unit Cost February 1984	Percent Change a/	Cost Impact on 1985 Budget a/
Programs with Decreases				
Laser Maverick missile, Navy	0.36	0.18	-49	-107
Harpoon missile, Air Force	0.81	0.47	-41	-28
HARM missile, Navy	0.58	0.39	-34	-159
Stinger missile, Army	0.13	0.09	-33	-103
MX missile	106.96	73.47	-31	-1,339
LSD-41 ship dock	347.65	243.00	-30	-209
SH-2F helicopter	15.55	11.73	-25	-23
P-3C aircraft	66.78	51.48	-23	-138
35 Other Systems Showing Unit Price Decreases	---	---	---	-1,946
Subtotal, decreases for 43 systems	---	---	---	-4,053
Programs with Increases				
Tomahawk missile	1.95	3.04	56	196
TR-1 aircraft	36.56	55.65	52	76
T-46 aircraft	7.43	11.02	48	36
Light armored vehicle, Navy	0.70	0.94	34	70
Patriot missile	1.44	1.87	30	252
AMRAAM missile, Air Force	1.77	2.17	23	70
Fighting vehicle	1.19	1.45	21	182
F-15 aircraft	34.70	41.15	19	310
23 Other Systems Showing Unit Price Increases	---	---	---	445
Subtotal, increase for 31 systems	---	---	---	1,637
Total Impact of 74 Systems				-2,416

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

a. Percent change and cost impact were calculated before rounding procurement unit costs.

table shows a net projected cost decrease of $2.4 billion since last year, compared with projected increases of $2.6 billion for 60 systems in CBO's analysis of the 1984 budget and $2.7 billion for 48 systems in CBO's analysis of the 1983 budget.

Table IV-20 shows that DoD estimates that the costs for 43 systems would be about $4 billion lower in 1985 than previously projected for the same year. The table also shows that 31 systems would experience cost increases totaling about $1.6 billion.

If the production level of a system has been changed, the change in unit costs is about what would be expected (see Table 21). In 10 cases quantities are revised upward and unit costs decline as expected. In 16 cases the production quantity is decreased and unit costs rise as expected. These 16 cases are signficant in that the DoD action in changing the level of production downward is contrary to the announced DoD policy of maintaining efficient production rates. The budget justification material already provided by DoD does not provide an explanation for the unit price changes.

Other Purchases. The Administration's current plan proposes reduced appropriations of about $5.6 billion from last year for planned equipment purchases, including ammunition, support vehicles, communications and electronics equipment, and Marine Corps and defense agency procurement.

Construction. Military construction programs for 1985 have been reduced by about $2.7 billion from the $9.9 billion projected by the Administration in January 1983. This decrease represents a scaling down of plans for modernization of troop facilities.

Operations and Maintenance. The proposed funding for operations and maintenance is $2.2 billion less than the Administration's previous estimates of $82.4 billion for 1985.

Pay Reductions. The Administration's 1984 defense plan proposed pay increases for 1985 of about 6.1 percent for civilians and 10.9 percent for military personnel. The Administration now proposes pay increases of 3.5 percent for civilians and 5.5 percent for military personnel.

Other Decreases. Proposed funding for military personnel, family housing, and atomic energy defense activities would decline by about $0.9 billion from last year's plan for 1985.

TABLE IV-21. CHANGE BETWEEN JANUARY 1983 AND FEBRUARY 1984 IN QUANTITY AND PROCUREMENT UNIT COST OF SELECTED WEAPONS IN THE ADMINISTRATION'S 1985 ACQUISITION PLAN (In percents)

Weapon System	Quantity Change	Procurement Unit Cost Change
Increasing Quantity and Decreasing Cost		
P-3C aircraft	50	-23
Harpoon missile, Navy	4	-3
HARM missile, Navy	49	-34
Tow missile, Navy	26	-7
Laser maverick missile, Navy	224	-49
TAGOS Surtass ship	50	-5
Hellfire missile, Navy	39	-12
Hawk missile, Marine Corps	14	-16
F-16 aircraft	25	-5
Harpoon missile, Air Force	70	-41
Decreasing Quantity and Increasing Cost		
Patriot missile	-28	30
Pershing II missile	-11	18
Fighting vehicle	-14	21
Bushmaster gun	-13	10
M88A1 recovery vehicle	-10	6
AV-8B aircraft	-33	11
Tomahawk missile	-49	56
Phoenix missile	-14	6
Stinger missile, Navy	-16	19
LCAC landing craft	-25	12
Captor torpedo system	-37	29
F-15 aircraft	-33	19
TR-1 aircraft	-20	52
T-46A aircraft	-52	48
IIR Maverick missile, Air Force	-21	1
AMRAAM missile, Air Force	-22	23

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

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Program Increases

Research and Development. In the aggregate, budget authority for research and development (R&D) programs for 1985 increased by about $1.8 billion over last year's plan. Unfortunately, the exact amount of this increase cannot be identified by individual program, because the Administration's previous projections of the total appropriation for RDT&E for 1985 was $2 billion more than the sum of the DoD projections of costs for individual programs.

Other Increases. The Administration's current plan proposes increased appropriations of $0.6 billion from last year for revolving funds, offsetting receipts, and other miscellaneous defense activities.

CHAPTER V. THE ADMINISTRATION'S NONDEFENSE SPENDING PROPOSALS

The Administration's fiscal year 1985 budget for nondefense spending programs--both on- and off-budget--proposes reductions that would lower outlays relative to CBO baseline projections by an estimated $7 billion in 1985 and by $131 billion from 1985 to 1989 (see Table V-1). This amounts to a reduction of 4 percent in projected nondefense outlays for the next five years under current laws and policies, and continues the scaling back of these programs. Over the past three years, legislative actions to date have reduced nondefense spending by an average of $70 billion a year over the 1985-1989 period.

Under the Administration's proposals, total nondefense spending (excluding interest costs) would rise from an estimated $522 billion in 1984 to $549 billion in 1985 and $667 billion in 1989. This represents an average increase of 5 percent per year, which is less than the projected growth for the economy. As a result, nondefense spending under the Administration's proposals would fall from 14.7 percent of GNP in 1984 to 12.4 percent in 1989 (see Table V-2).

The President's proposals for the nondefense programs are summarized in Table V-1. All proposed changes are shown relative to the CBO baseline. Baseline spending projections are designed to show what outlays would be in future years if current policies were continued without change. 1/

The President's budget proposes total reductions in entitlements and mandatory programs of $46 billion from 1985 to 1989. The largest proposed reduction is in farm price supports, where the President's budget proposes

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1. For entitlements and other mandatory spending programs and offsetting receipts, the baseline spending projections assume that current laws will remain unchanged and that program spending will respond to assumed economic and demographic changes as in the past. For discretionary programs, federal spending depends on annual appropriations actions. The 1985-1989 projections for these appropriated accounts represent a continuation of the policies and program levels embodied in the 1984 appropriation. Generally, the projections assume that budget authority is kept constant in real terms--that is, to keep pace with a measure of inflation appropriate to the particular program.

TABLE V-1. CBO ESTIMATE OF NONDEFENSE SPENDING REDUCTIONS IN THE ADMINISTRATION'S 1985 BUDGET PLAN (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
			Unified Budget			
CBO Baseline Outlays Nondefense Programs	541	573	613	657	699	
Proposed Changes						
Entitlements and Other Mandatory Spending	-4	-6	-9	-12	-15	-46
Nondefense Discretionary Spending	-2	-5	-7	-12	-17	-44
Offsetting Receipts	*	-1	-2	-4	-6	-13
Total Changes	-6	-13	-19	-28	-38	-103
President's Budget as Estimated by CBO	535	560	595	629	661	
			Off-Budget			
CBO Baseline Outlays Nondefense Programs	14	14	15	16	15	
Proposed Changes	*	-4	-7	-8	-9	-28
President's Budget as Estimated by CBO	14	9	8	8	6	

* Less than $500 million.

SOURCE: Congressional Budget Office

TABLE V-2. THE ADMINISTRATION'S NONDEFENSE BUDGET AS ESTIMATED BY CBO (By fiscal year)

	1984	1985	1986	1987	1988	1989
Outlays in Billions of Dollars						
Entitlement and Other Mandatory Spending						
Social Security and Railroad Retirement	179	190	203	217	234	250
Medicare and Medicaid	84	95	105	118	132	147
Other Entitlements and Mandatory Spending	133	138	141	144	148	152
Nondefense Discretionary	157	162	166	174	179	183
Offsetting Receipts	-46	-49	-54	-58	-64	-71
Subtotal, Unified Budget	507	535	560	595	629	661
Off-budget	15	14	9	8	8	6
Total, Unified Budget and Off-budget	522	549	570	603	637	667
Outlays as a Percent of GNP						
Entitlement and Other Mandatory Spending						
Social Security and Railroad Retirement	5.0	4.9	4.8	4.7	4.7	4.6
Medicare and Medicaid	2.4	2.4	2.5	2.6	2.6	2.7
Other Entitlements and Mandatory Spending	3.7	3.5	3.3	3.1	3.0	2.8
Nondefense Discretionary	4.4	4.1	3.9	3.8	3.6	3.4
Offsetting Receipts	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Subtotal, Unified Budget	14.2	13.7	13.2	12.9	12.6	12.3
Off-budget	0.4	0.4	0.2	0.2	0.2	0.1
Total, Unified Budget and Off-budget	14.7	14.0	13.4	13.1	12.8	12.4

freezing target prices at the 1984 crop-year levels mandated in the 1981 Agriculture Act. It is estimated that this proposal would save $15 billion over the 1985-1989 period compared to CBO's baseline projections. The President's budget also proposes reducing federal Medicaid and Medicare spending by $9 billion. In addition, the President is proposing reductions in spending for federal retirement and disability programs, means-tested benefits, and other entitlement or mandatory spending. As a result, outlays in this area would grow at an average rate of 6.7 percent annually from 1984 to 1989, compared to 7.2 percent per year under baseline assumptions.

Outlays under the Administration's request for nondefense discretionary programs included in the unified budget would grow much more slowly--at an annual rate of 3.1 percent from 1984 to 1989. As a result, nondefense discretionary spending would fall $44 billion, or about 5 percent, below the CBO baseline from 1985 to 1989. While a number of individual programs would have funding reduced or be eliminated entirely, funding for most discretionary programs would be held at about 1984 levels or increased slowly over the 1985-1989 period. This would result in on-budget nondefense discretionary spending falling from 4.4 percent of GNP in 1984 to 3.4 percent in 1989. Part of the on-budget spending increase, however, reflects a proposed shift in the financing of foreign military assistance, from off-budget to the unified budget. When adjusted to include the off-budget effects of this change, nondefense discretionary spending is projected to grow at an annual rate of 2.6 percent from 1984 to 1989, and total outlays over this period would fall $62 billion below the baseline.

The President's budget proposes increases in offsetting receipts of $13 billion. Most of this increase, $11 billion, would come from a proposed increase in the Supplemental Medical Insurance premiums.

In addition to the savings proposed for activities on the unified budget, the Administration is proposing significant reductions in off-budget spending. Such spending includes major federal credit activities financed by the Federal Financing Bank, as well as oil purchases for the Strategic Petroleum Reserve and Postal Service operations. Under the President's proposals, outlays for off-budget activities are projected to decline from $15 billion in 1984 to $6 billion in 1989. Most of this savings reflects proposed changes in foreign military sales financing, but significant reductions are proposed for credit programs of the Rural Electrification Administration and the Farmers Home Administration. As a result, total off-budget outlay savings would be about $28 billion in 1985-1989.

Each of these major spending categories will be discussed in more detail in the remainder of the chapter.

ENTITLEMENTS AND OTHER MANDATORY SPENDING

Entitlement programs provide benefits to persons, businesses, or units of government that meet eligibility requirements established in law. Social Security is the largest single entitlement program with outlays constituting about 20 percent of the entire federal budget. Other major entitlement programs include Unemployment Insurance and Railroad Retirement, Civil Service and Military Retirement and Disability; Medicare and Medicaid; Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), and Food Stamps; farm price supports; Veterans' Pensions, Compensation, and Readjustment Benefits; and Guaranteed Student Loans (GSLs).

Growth in entitlements in the President's budget continues at the slower rate of the past three years, following very rapid growth in the 1960s and 1970s. By 1980, entitlements were 10.9 percent of GNP--an increase from 5.4 percent in 1965. They increased further to 12.4 percent of GNP in 1983, but are projected to decline to 10.2 percent by 1989 under the President's budget proposals. Legislative cuts, reduced inflation, and lower unemployment are the main causes of the projected decline in entitlement outlays relative to GNP.

The Administration's budget shows outlays for entitlements and other mandatory spending programs increasing by $153 billion over the next five years, from $396 billion in 1984 to $549 billion in 1989 (see Table V-3). Social Security and Railroad Retirement, Medicare and Medicaid, and federal employee retirement and disability account for almost all of this projected increase.

The President's budget proposes legislative reforms to entitlement programs that would reduce spending by an estimated $4 billion in fiscal year 1985 and by $46 billion from 1985 to 1989 (see Table V-4). Many of the legislative proposals contained in this year's budget were also proposed in previous budgets. The range of entitlement programs targeted for reductions, however, is smaller than last year. Little or no legislation is proposed for the major social insurance programs including Social Security, Railroad Retirement, and Unemployment Insurance. The Congress enacted major reforms to both the Social Security and Railroad Retirement programs last year. In Unemployment Insurance, the Federal Supplemental Compensation program was extended through March 31, 1985. The President's budget does not propose extending the program beyond this date.

Relatively large reductions are proposed in health, federal retirement and disability, AFDC, Food Stamps, and farm price supports. These and other legislative proposals are discussed in the following section.

TABLE V-3. PROPOSED OUTLAYS FOR ENTITLEMENTS AND OTHER MANDATORY SPENDING PROGRAMS AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
Social Security and Railroad Retirement	179	190	203	217	234	250
Federal Retirement and Disability	39	40	43	46	49	52
Medicare and Medicaid	84	95	105	118	132	147
Unemployment Trust Fund	24	22	22	22	20	20
SSI, AFDC, Child Support, and Food Stamps	29	29	31	32	34	35
Veterans' Programs	16	17	17	18	18	18
Farm Price Supports	6	11	10	10	9	8
General Revenue Sharing	5	5	5	5	5	5
Other a/	15	14	13	12	14	13
Total	396	423	449	479	514	549

a. Includes a variety of programs providing educational assistance, nutrition assistance, social and rehabilitation services, and aid to certain businesses.

Federal Retirement and Disability

The President's 1985 budget proposes delaying scheduled cost-of-living adjustments (COLAs) in all federal employee retirement programs. In addition, structural changes are proposed for civil service, military, and foreign service retirement.

TABLE V-4. CBO ESTIMATE OF THE ADMINISTRATION'S PROPOSED REDUCTIONS IN ENTITLEMENTS AND OTHER MANDATORY SPENDING (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays—Entitlements and Other Mandatory Spending	427	455	488	526	564	
Proposed Changes						
Federal retirement and disability	-1	-1	-2	-2	-2	-8
Medicare and Medicaid	-1	-2	-2	-2	-2	-9
Food Stamps, SSI, AFDC, and Child Support	-1	-1	-1	-1	-1	-3
Farm price supports	*	-1	-3	-5	-6	-15
Other a/	-1	-1	-2	-3	-3	-10
Total Changes	-4	-6	-9	-12	-15	-46
President's 1985 Budget as Estimated by CBO	423	449	479	514	549	

* Less than $500 million.

a. Includes reductions in Guaranteed Student Loans, Federal Employees Health Benefits, Pension Benefit Guaranty Corporation, Child Nutrition, Veterans' Compensation, and Rehabilitation Services. Includes a benefit increase for Veterans' Readjustment benefits.

Civil Service Retirement and Disability. The Administration recommends the adoption of pending reconciliation legislation, delaying the COLAs until January of each year. Retirees under age 62 would receive half of the actual COLA in 1985. The budget also proposes limiting the COLA to 55 percent for benefits above $10,000 starting in 1985. The

$10,000 limit would increase with subsequent COLAs. Finally, beginning in 1986, the budget proposes limiting the COLA to the lesser of the change in federal pay or in the Consumer Price Index (CPI). CBO has estimated savings of $0.4 billion in 1985 reflecting delay of the 1984 and 1985 COLAs; 1989 savings of $1.6 billion result about equally from the COLA delay and the COLA reduction for benefits above $10,000 (in 1985 dollars).

In addition, the budget again proposes increasing employee and matching employer contributions from the current 7 percent to 8 percent in 1985 and to 9 percent thereafter. CBO estimates increased revenues of $0.7 billion in 1985 and $7 billion from 1985 to 1989 as a result. The proposals to increase revenues and reduce COLAs attempt to close the gap between contributions to Civil Service Retirement and benefit payments from the Civil Service Trust Fund. Current projections show 2.0 million annuitants in 1985 but only 2.7 million active employees, and payments of $23.5 billion but contributions of only $9.2 billion.

Military Retirement. In addition to the COLA delay, the President's budget proposes changing the calculation of retirement benefits. The calculation is now based on years of service and final basic pay, which would be changed to the average of the highest three years of basic pay. This change would become effective for personnel entering the service after September 1980 and thus would have almost no budget effect during the 1985-1989 period.

Other Retirement and Disability Programs. The proposed COLA delay would also affect Foreign Service Retirement, the Retired Commissioned Health Officers Fund, the Federal Employee Compensation program, and the Foreign Service Retirement and Disability Fund. In addition to delaying the COLA, the budget also proposes changes in Foreign Service Retirement similar to the changes in Civil Service Retirement described above.

Medicare and Medicaid

Medicare and Medicaid are major entitlement programs that provide federal funding for health services and are the fastest growing programs in the nondefense budget. Medicare, which includes the Hospital Insurance (HI) program and the Supplementary Medical Insurance (SMI) program, covers hospital, physician, and other medical costs for persons aged 65 and over and for most disabled persons entitled to Social Security cash benefits. Medicaid, through federal and state financing, pays for health services for low-income persons. In total, Medicare and Medicaid provide benefits to about 49 million people, at an estimated cost of $84 billion in 1984.

The Administration's 1985 budget proposals would curb the growth in federally funded medical care programs, both by shifting costs to beneficiaries and by freezing physicians' fees. The Administration's Medicare and Medicaid proposals would add $20 billion to more than $40 billion in savings for the 1985-1989 period already enacted in the Omnibus Budget Reconciliation Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Social Security Act of 1983. These reductions included transfers of Medicare costs to both beneficiaries and providers. Even with the Administration's latest proposals, federal Medicare and Medicaid spending is projected to increase by 75 percent between 1984 and 1989, and rise relative to GNP from 2.4 percent to 2.7 percent.

The Administration's proposed Medicare legislation is targeted mainly toward decreasing spending in SMI rather than in HI. CBO estimates these proposals would save $6 billion in SMI, $1 billion in HI, and $11 billion in premiums over the 1985-1989 period. The SMI proposals include freezing physicians' fees for one year, indexing the deductible, and delaying eligibility for one month. The HI proposals include delaying eligibility for one month, and requiring a copayment for durable medical equipment used in conjunction with home health care.

Although the Administration's Medicare proposals have been suggested in previous budgets and have not yet been enacted, Congressional committees have reported legislation incorporating some of these savings. Last year the House Ways and Means Committee reported a bill (H.R. 4170) that included a freeze on physicians' fees and an increase in premiums. The reconciliation bill reported by the Senate Budget Committee (S. 2062) contained provisions for a freeze on physicians' fees, a premium increase, and an increase in the SMI deductible.

In Medicaid, the President's proposed legislation is estimated to save $2 billion between 1985 and 1989 relative to CBO's baseline projections. This saving would be achieved largely by extending the current state Medicaid penalties on excessive cost growth and by requiring nominal copayments from beneficiaries for many services. These proposals also were included in last year's budget but have been neither enacted nor included in House or Senate 1983 reconciliation bills.

Major Means-Tested Transfer Programs

Means-tested transfer programs--Aid to Families with Dependent Children, Food Stamps, and Supplemental Security Income--provide the major governmental support to low-income families. Significant reductions are again proposed for these programs in the President's budget, although these reductions are well below those in last year's budget. CBO's estimated

savings for the President's proposals are $0.6 billion in 1985 and $2.8 billion over the 1985-1989 period.

In AFDC, Food Stamps, and SSI, the President's proposals were in general also incorporated in last year's budget. The major proposals affecting AFDC would require job search and workfare for employable recipients, reduce benefits to recipient families who share shelter with nonrecipients, and require all family members with income to be part of the AFDC unit. In the Food Stamp program, mandatory workfare is proposed, as are increased error-rate sanctions on the states for overpayments. In SSI, the Administration proposes recapturing overpayments and certain other duplicate payments from OASDI benefits received by SSI recipients.

CBO's estimated savings for these proposals are about 40 percent less than the Administration's. The greatest difference is in estimates of potential savings from the workfare proposals, particularly in AFDC. Workfare requires employable adult recipients to work in exchange for their benefits. Current CBO estimates show small costs in AFDC from workfare instead of savings. Whether workfare costs or saves money in AFDC will not be known until reliable findings of workfare's cost effectiveness become available.

The Child Support Enforcement (CSE) program serves AFDC and non-AFDC families by enforcing support obligations owed by absent parents to their children. While not means-tested, it is closely related to AFDC because collections of support for AFDC children offset AFDC expenditures. The President's budget includes proposed changes that are almost identical to the child support provisions in H.R. 4325, which was passed by the House late in 1983. This bill would require states to use certain enforcement techniques such as wage withholding. It would also alter incentive payments to states from 12 percent of AFDC collections to a range of 4-10 percent of AFDC and non-AFDC collections, the precise percentage would depend on state ratios of collections to expenditures. In addition, the Administration proposes to reduce the federal share of CSE expenditures from 70 percent to 65 percent and to require states to impose fees for applications and delinquent payments. CBO's estimated savings are somewhat higher than the Administration's after 1985.

Farm Price Supports

Agricultural price supports provide price and income protection to farmers. Expenditures are made through a number of agricultural commodity programs designed to support and stabilize farm prices and incomes. The programs use several tools, including commodity loans and purchases, direct payments, and supply controls. The principal commodities

covered by these programs are wheat, corn and other feed grains, rice, upland cotton, tobacco, peanuts, milk, and wool.

The President's primary legislative initiative is to freeze target prices at the 1984 crop-year levels mandated in the 1981 Agriculture Act. It is the difference between target prices and market prices that determines the rate at which deficiency payments will be made on each eligible farmer's crop production. Freezing these levels is estimated to save $1.4 billion in 1985, and $14.8 billion during the 1985-1989 period. In addition, the President proposes to make the honey price support program discretionary.

The price support proposal comes at a time of rising farm support payments. Outlays for agricultural price support programs rose sharply in 1982 and again in 1983 to a record $18.8 billion, nearly five times the 1981 level. This dramatic rise in spending reflected a sharp decline in farm prices resulting from large U.S. crops and weak export demand.

Outlays are expected to decline in 1984 to $6.1 billion, because of the sharply reduced production of drought-stricken crops and the payment-in-kind (PIK) program. Higher prices in feed grains, rice, and cotton are projected to reduce deficiency payments and commodity loans, particularly in the case of feed grains where liquidation of grain under loan in the farmer-owned-reserve is expected to result in net repayments of $2.5 billion. Dairy outlays are also expected to decline from a record $2.5 billion in 1983 to an estimated $1.5 billion as a result of lower support prices and a paid diversion program required by the Dairy and Tobacco Act of 1983. Outlays would be projected even lower but for an estimated $1.4 billion to cover export credit defaults that the President has included in 1984 estimated outlays.

Outlays in 1985 are projected to increase to $11.0 billion because rising crop production is expected to reduce prices. Crop production is expected to rebound from last year's drought and to increase further as a result of less restrictive acreage reductions (the PIK program is continued only for the 1984 wheat crop). Deficiency payments are estimated to increase from $0.9 billion in 1984 to $2.6 billion in 1985, though total direct payments will rise only $1 billion. Net commodity lending is estimated to increase by $2.4 billion. Dairy costs are projected to be $0.5 billion above 1984 levels as the diversion program ends March 31, 1985, and lower grain prices encourage greater feeding.

Other Proposed Changes

This residual category includes a variety of programs providing educational assistance, nutrition assistance, social and rehabilitation

TABLE V-5. CBO ESTIMATES OF THE ADMINISTRATION'S PROPOSED REDUCTIONS IN THE "OTHER" CATEGORY OF ENTITLEMENTS AND MANDATORY SPENDING
(By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays--Other Entitlements and Mandatory Spending	35	35	35	37	36	
Proposed Changes						
Guaranteed Student Loans	-0.3	-0.3	-0.4	-0.5	-0.5	-2.0
Federal Employees' Health Benefits	---	-0.2	-0.3	-0.4	-0.5	-1.5
Pension Benefit Guaranty Corporation	-0.2	-0.2	-0.2	-0.2	-0.3	-1.0
Child Nutrition	---	-0.1	-0.1	-0.2	-0.3	-0.7
General Revenue Sharing	---	---	-0.3	-0.5	-0.7	-1.5
Rehabilitation Services	-0.1	-0.2	-0.2	-0.2	-0.3	-1.0
Veterans' Programs	-0.3	0.3	0.2	-0.0	-0.1	-0.1
Other	-0.2	-0.2	-0.4	-0.4	-0.4	-1.6
Total Changes	-1.1	-0.8	-1.8	-2.5	-3.1	-9.3
President's Budget as Estimated by CBO	34	34	33	34	33	

services, aid to state and local governments, and aid to certain businesses (see Table V-5).

Guaranteed Student Loans. The Administration again proposes eliminating the $30,000 income cap and making all students subject to a need analysis for GSLs. Under this proposal 800,000 of the 2.8 million borrowers would either be ineligible for a loan or have their loan amount reduced. The vast majority are independent students, part-time students,

and students who attend low-cost two-year schools. New loan volume would decrease by an estimated $1.1 billion in 1985 with similar reductions in the outyears. By 1989, this change would save an estimated $450 million. The Administration also proposes making state guarantee agencies share more of the cost of the GSL program.

Government Contributions to Employer Health Insurance. The President's budget proposals for federal employees' health benefits (FEHB) would reduce outlays by $0.2 billion beginning in 1986. The federal government's contribution would be based on a broader measure of cost changes, and a wider range of plans would be allowed to participate in the program. Also, the Administration proposes changing contributions for annuitants' health benefits in the Postal Service and other off-budget entities.

Pension Benefit Guaranty Corporation. To increase revenues, the Administration is proposing an increase in the single-employer premium rate from $2.60 to $6.00 per participant, effective January 1, 1984.

Child Nutrition. The President's budget proposes several changes in the child nutrition programs. For child care and summer food service programs, a block grant would be fixed at the projected 1985 level. For the school lunch program, the Administration proposes tying the reimbursement rate for all lunches to a food price index and slightly lowering reimbursement rates for reduced-price lunches.

General Revenue Sharing. The President's budget proposes funding general revenue sharing at its 1984 level throughout the 1985-1989 period. The CBO baseline is held at the constant authorization ceiling through 1986, but is inflated thereafter. By 1989, the President's spending request is 13 percent below CBO's baseline.

Rehabilitation Services. The President's budget request for basic grants is below the levels stated in recently passed legislation for 1984-1987. In 1988 and 1989, the President's request grows more slowly than the CBO baseline, which is increased by the CPI. By 1989, the difference is over $300 million.

Veterans' Programs. The President's budget proposes that in Veterans' Compensation cost-of-living adjustments be given every April, saving about $150 million each year. In Readjustment Benefits, the Administration proposes a 15 percent increase in benefit levels effective January 1, 1985, costing about $200 million a year.

The budget also includes major changes in the operation of the home-loan guarantee program that would be effected without legislation: halting the acquisition of property at foreclosure sales involving loans guaranteed by the Veterans Administration (VA); eliminating VA financing of the sale of real property owned by the agency; barring repurchase agreements on all future sales of loan assets; and terminating the loan refunding program. As a result, costs attributable to property acquisitions would be eliminated, followed about a year later by the elimination of collections that would have resulted from the sale of the ensuing vendor loan. Thus outlays in 1984 and 1985 would be more than $600 million below baseline outlays, partially offset in 1986 and 1987 by $226 million more in outlays from the drop in collections. In later years, there should be a small net savings.

NONDEFENSE DISCRETIONARY SPENDING

Many nondefense programs are considered "discretionary," in that the law establishes no entitlement to benefits from them. The Congress exercises its discretion in setting spending levels for these programs through the appropriations process, either by appropriating budget authority or by establishing loan limits, expenditure limits, or obligation ceilings. While most of such spending appears in the unified budget, a portion is defined in law as "off-budget" and is not counted in the budget totals. 1/

Outlays for on-budget discretionary programs grew more slowly than entitlements during the 1970s, but still increased from 4.5 percent of GNP in 1970 to 5.5 percent by 1980. Over the next three years, there was little growth in this category; 1983 outlays were about $144 billion, down to 4.4 percent of GNP and less than $3 billion above the 1980 level. Some growth is expected for 1984, in part attributable to spending increases enacted under the Surface Transportation Assistance Act of 1982 (Public Law 97-424), the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248), and the Emergency Jobs Appropriations Act of 1983 (Public Law 98-8). As a result, on-budget 1984 outlays are expected to be $157 billion, an increase of 9 percent over the 1983 level.

Under CBO's baseline projections for discretionary programs, which allow spending to keep pace with inflation, on-budget outlays would grow by about 5 percent per year over the next five years, rising from $157 billion in 1984 to $200 billion in 1989. The Administration's 1985 budget proposes to

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1. A separate discussion of the President's proposals for off-budget spending appears later in this chapter.

hold the growth of programs in this category to about 3 percent per year over the next five years, with outlays reaching $183 billion by 1989 (see Table V-6). If fully implemented, the budget would result in outlay savings of $2 billion in 1985, and a total on-budget deficit reduction of $44 billion over the 1985-1989 period, relative to the CBO baseline projections for discretionary programs. As a consequence, spending for nondefense discretionary programs in 1985 would be 1.2 percent below the baseline and 4.1 percent of GNP. By 1989, it would fall 9 percent below the baseline and represent only 3.4 percent of GNP.

This overall pattern does not apply uniformly to all types of discretionary spending. The President's budget includes proposed increases in certain areas and decreases in others. As shown in Table V-7, the largest on-budget increases are for foreign aid, amounting to $17 billion over five years. This increase, however, is more than offset by a $19 billion decrease in off-budget spending in the same area. Significant reductions below the baseline are proposed for benefits and services to individuals, infrastructure, assistance to business and commerce, and various off-budget activities. Federal government operations and research and development would be maintained at close to baseline levels over the five-year period.

Aid to Foreign Governments and International Organizations

This category includes programs for development and security assistance, contributions to international organizations, and international monetary programs. The substantial on-budget outlay increase projected for these activities largely reflects the President's proposal that beginning in 1985 all foreign military sales be provided as direct loans or grants, instead of the current mix of grants and guaranteed loans provided off-budget through the Federal Financing Bank (FFB). For 1985, grants and forgiven direct loans would increase by a total of $1.6 billion over the 1984 level; concessional direct loans would increase by $0.5 billion, while loans at Treasury rates would be reduced by $2.4 billion. 2/ The amount of concessionality in the financing package would increase from 30 percent in 1984 to 60 percent, increasing the ultimate cost to the federal government of the 1985 assistance by $1.8 billion, on a present-value basis. (This cost would be reflected in lower interest receipts and principal repayments in future years.) On-budget outlays for foreign military sales assistance would be $1.3 billion above the baseline in 1985 (see Table V-8), but off-budget outlays of the FFB would be reduced by $1.2 billion. Over the 1985-1989

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2. Excluding funds for the Central American assistance program.

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TABLE V-6. PROPOSED OUTLAYS FOR NONDEFENSE DISCRETIONARY SPENDING PROGRAMS AS ESTIMATED BY CBO a/
(By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
Aid to Foreign Governments and International Organizations	11	14	14	16	17	17
Federal Government Operations	24	25	25	25	26	27
Benefits and Services to Individuals	50	50	51	52	53	54
Transportation, Natural Resources, and Other Infrastructure	45	47	47	48	47	47
Assistance to Business and Commerce	9	7	6	6	6	6
Research and Development	18	19	20	21	21	22
Civilian Agency Pay Raises	1	*	3	5	7	10
Total	157	162	166	174	179	183

* Less than $500 million.

SOURCE: Congressional Budget Office.

a. Does not include off-budget spending, which is shown in Table V-13.

TABLE V-7. CBO ESTIMATE OF THE ADMINISTRATION'S PROPOSED REDUCTIONS IN NONDEFENSE DISCRETIONARY SPENDING a/ (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays--Nondefense Discretionary Programs	164	171	181	191	200	
Proposed Changes						
Aid to foreign governments and international organizations	2	3	4	4	4	17
Benefits and services to individuals	-3	-5	-7	-8	-10	-33
Transportation, natural resources, and other infrastructure	*	-1	-2	-4	-6	-14
Assistance to business and commerce	-1	-2	-2	-3	-3	-12
Other	*	*	*	-1	-1	-2
Total Changes	-2	-5	-7	-12	-17	-44
President's Budget as Estimated by CBO	162	166	174	179	183	

* Less than $500 million.

SOURCE: Congressional Budget Office.

a. Does not include off-budget spending, which is shown in Table V-13.

TABLE V-8. PROPOSED FUNDING CHANGES FOR AID TO FOREIGN GOVERNMENTS AND INTERNATIONAL ORGANIZATIONS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays a/	11.2	11.5	11.9	12.4	12.8	
Proposed Changes						
Foreign military sales financing a/	1.3	2.2	3.3	3.9	4.0	14.7
Assistance to Central America	0.8	0.7	0.8	0.8	0.8	3.7
Other	0.3	-0.1	-0.2	-0.5	-0.8	-1.3
Total Changes	2.4	2.8	3.9	4.1	4.0	17.2
President's Budget as Estimated by CBO a/	13.6	14.3	15.8	16.5	16.7	

SOURCE: Congressional Budget Office.

a. Excludes off-budget outlays of the FFB, which would be reduced $18.8 billion over the 1985-1989 period under the President's proposal (see Table V-13.

period, total outlays (on-budget and off-budget) for these programs would be $4.1 billion below the baseline, resulting from reductions in the total amounts of assistance provided. (The on-budget outlay increase would be $14.7 billion, compared to an off-budget decrease of $18.8 billion over the five years.)

The President is also requesting funds for assistance to Central America--a $500 million supplemental for 1984, and appropriations of $750 million a year through 1989. The six-year package, with outlays totaling $3.7 billion over the period, encompasses both economic and military

assistance intended to implement the recommendations of the Commission on Central America. Other major budget proposals include funding for payments to the Marshall Islands and the Federated States of Micronesia ($0.9 billion in the 1985-1989 period) and reductions in multilateral assistance (a total of $0.7 billion below the baseline in 1985-1989). The President's request for other programs is close to baseline levels for 1985, but below the baseline by a total of $1.5 billion from 1986 to 1989.

Benefits and Services to Individuals

The largest portion of nondefense discretionary spending is for benefits and services to individuals--including housing, education, employment and job training, veterans' hospitals, health and legal services, and assistance in paying energy costs. Such spending was the fastest-growing area of discretionary spending during the 1970s, growing at an annual rate of more than 14 percent. Since then outlays have increased only slightly, from $47 billion in 1980 to $48 billion in 1983.

Under the President's budgetary proposals, discretionary spending for benefits and services to individuals would increase by an average of 1.7 percent annually from 1985 to 1989, reaching $54 billion in 1989. Outlays in 1985 would be $2.5 billion, or 5 percent, below the baseline level. By 1989, outlays would be $10.3 billion, or 16 percent, below the baseline. Total savings from 1985 through 1989, relative to the baseline, would be $33 billion (see Table V-9).

Housing Programs. The President's 1985 budget request proposes a significant change in the means by which the Department of Housing and Urban Development (HUD) would provide low-income rental assistance. Beginning in 1985, most new section 8 subsidy agreements would be in the form of five-year certificates (vouchers) rather than the 15- to 30-year contracts currently typical of the program. In addition, HUD plans to convert units currently under payment to voucher assistance when contracts are due for renewal.

The President has requested about $6.2 billion in new budget authority for section 8 and public housing commitments in 1985. With shortened contract terms, this amount plus about $2.9 billion in authority carried over or recaptured in 1985 is estimated by HUD to be sufficient to subsidize 100,000 additional units, about the same number currently estimated for 1984. The budget authority contained in the CBO baseline is based on 1984 new authority of $9.3 billion (the amount appropriated in 1984 less $615 million that is to be used for rental rehabilitation and construction). The baseline, however, does not include the assumption that most assistance will be in the form of vouchers.

TABLE V-9. PROPOSED FUNDING CHANGES FOR BENEFITS AND SERVICES TO INDIVIDUALS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays	52.9	55.8	58.7	61.6	64.7	
Proposed Changes						
Housing programs	-0.7	-1.3	-2.1	-2.8	-3.5	-10.4
Education programs	-0.3	-1.2	-1.9	-2.5	-3.3	-9.2
Training, employment and social services programs	-0.8	-1.4	-1.8	-2.1	-2.5	-8.5
Veterans' programs	0.2	0.3	0.7	1.0	1.2	3.4
Other	-1.0	-1.5	-1.7	-1.9	-2.3	-8.4
Total Changes	-2.5	-5.1	-6.7	-8.4	-10.3	-33.0
President's Budget as Estimated by CBO	50.4	50.7	52.0	53.2	54.4	

SOURCE: Congressional Budget Office.

In addition to the shift to voucher assistance and the associated reduction in budget authority, the Administration has proposed reduced funding levels relative to the baseline for two other housing assistance programs. Commitments to make direct federal loans for the construction of housing for the elderly and the handicapped under HUD's section 202 program are limited to 10,000 units in the President's budget. Loan authority estimated to be sufficient for 14,000 units was provided in 1984 appropriations and is included in the baseline. Restricted funding levels are also proposed for housing assistance to low-income rural residents. The

Farmers Home Administration's reduced interest-rate direct loan and rental assistance programs will obligate almost $3.4 billion in 1984. The President has requested about $2.4 billion for 1985.

Education Programs. Nearly one-third of the five-year outlay savings in benefits and services to individuals is projected in education programs. The President is proposing 1985 budget authority $0.4 billion below the 1984 funding levels. These savings would be obtained by reducing funding by $0.7 billion for student assistance, aid to postsecondary institutions, and impact aid payments, and increasing funding by $0.3 billion for quality education and math and science education programs. Additional savings are projected in 1985 and subsequent years because funding for most of the other education programs is held to the 1984 funding levels through 1989. As a result, the President's 1989 outlays are $3.3 billion or 21 percent below the baseline projection for that year.

Employment, Training, and Social Service Programs. These programs are also targeted for significant reductions, with outlays in 1985 estimated to be $0.8 billion, or 11 percent, below the baseline. Reductions in 1989 are $2.5 billion, which is 27 percent of baseline levels. Major funding reductions include the elimination of the work incentive program and the community service block grant program. Funding for these programs totaled $0.7 billion in 1984.

Veterans' Programs. The President's 1985 budget authority request of $10.5 billion for veterans' programs exceeds the 1984 funding level by $0.9 billion and the 1985 CBO baseline by $0.3 billion. The President's funding levels continue to grow through 1989 when they exceed the baseline level by $1.4 billion. As a result, outlays for veterans' programs would exceed the baseline by $0.2 billion in 1985 and by a total of $3.4 billion over the 1985-1989 period. The increases are primarily in funds for major construction projects and to operate the Veterans Administration health care system. Real increases in construction funding are planned to meet the rise in demand for VA health care--particularly nursing home care--that is expected over the next decade. Increased funding for medical care is requested to staff and operate the new facilities scheduled to open during the period and to upgrade existing programs.

Other Programs. The President's request is significantly below baseline levels in other programs in this category, including the Legal Services Corporation, for which no 1985 request is made, low-income energy assistance, refugee and entrant assistance, and the Special Supplemental Feeding Programs for Women, Infants, and Children (WIC).

Transportation, Natural Resources, and Other Infrastructure

Close to 30 percent of nondefense discretionary spending is devoted to the construction, operation, management, and maintenance of the nation's physical resources--including the major transportation systems, pollution control facilities, forests, parks, and other public lands, water, mineral, and other natural resources, and community development projects. Spending for these programs dropped from $44 billion in 1980 to $40 billion in 1983. Outlays in 1984, however, are estimated to rise sharply, to $45 billion, primarily reflecting increased highway, airport, and airways funding, as well as spending from the 1983 jobs bill and a one-time payment to the FFB for defaulted Amtrak loans. Even then, 1984 spending will be only slightly above the 1980 level.

Under the President's proposals, spending would grow little over the next few years, averaging about $47 billion a year. This represents a reduction of $14 billion, or 6 percent, below the baseline outlay projections over the 1985-1989 period. Outlays in 1985 would be $0.4 billion, or about 1 percent, below the baseline level (see Table V-10).

The major increases in the President's budget, relative to the baseline, are for programs of the Federal Aviation Administration (FAA). Proposed 1985 funding for FAA facilities and equipment is $1.7 billion, more than double the $750 million appropriated for 1984. This increase is part of the continuing program to modernize the air traffic control system. As a result, annual outlays are projected to grow from $0.7 billion in 1985 to $1.4 billion in 1989.

The Administration's budget for most other transportation programs is below the CBO baseline level. Federal-aid highways outlays, under the President's proposals, would be $0.1 billion below the baseline in 1985 and $3.7 billion lower over the 1985-1989 period, because the proposed obligation ceilings are more restrictive than those established in the Surface Transportation Assistance Act of 1982. (The President also assumes that 1987-1989 ceilings would remain at the proposed 1986 level of $14.8 billion.) The budget also provides for reductions in transit funding, with 1985 budget authority $0.2 billion below the 1984 level. Appropriations for formula grants would be held at the 1984 level of $2.4 billion through 1989, but the use of such grants for operating assistance would be gradually phased out. Since capital grants are spent much more slowly than operating funds, and because funding would be held below the baseline level, mass transit outlays over the 1985-1989 period would be $7.2 billion below the baseline. Funding for Amtrak subsidies would be held almost constant, at $680-690 million per year, below the $716 million appropriated for 1984. Resulting outlay savings over the five-year period would be $0.7 billion.

TABLE V-10. PROPOSED FUNDING CHANGES FOR TRANSPORTATION, NATURAL RESOURCES, AND OTHER INFRASTRUCTURE (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays	47.0	48.3	49.9	51.7	53.5	
Proposed Changes						
Airports and airways	0.4	0.5	0.7	0.6	0.4	2.6
Other transportation	-0.6	-0.8	-1.3	-2.7	-3.7	-9.1
Natural resources, environment and energy	-0.1	-0.4	-0.8	-1.2	-1.5	-4.0
Community and regional development	-0.2	-0.5	-0.7	-1.0	-1.4	-3.8
Total Changes	-0.4	-1.1	-2.2	-4.3	-6.2	-14.2
President's Budget as Estimated by CBO	46.5	47.2	47.7	47.4	47.2	

SOURCE: Congressional Budget Office.

Under the President's budget, spending for infrastructure activities other than transportation would be $23 billion in 1985, about 1 percent above the 1984 level, then decline slightly each year to $22 billion in 1989. Budget authority in 1985 would be $0.9 billion, or 4 percent, below the baseline, while outlays would be $0.2 billion below. Over the 1985-1989 period, outlays would be $7.8 billion below the baseline. The spending reductions span many areas of activity--energy conservation programs ($0.4 billion below the baseline over five years), water and land conservation programs (funding reduced by almost one-third in 1985), land acquisition for national parks (funded at half the 1984 level), and operations of the National Oceanic and Atmospheric Administration (reduced by 10 percent). Funding

for wastewater treatment plant construction grants and abatement, control, and compliance activities of the Environmental Protection Agency (EPA) would be held at about the 1984 level of $2.8 billion in all years, resulting in outlays $0.8 billion below the baseline over the 1985-1989 period. Programs of the Economic Development Administration and the Appalachian Regional Commission would be terminated, while community development block grants, urban development action grants, major Farmers Home Administration programs, and Indian programs would be held at or near the 1984 funding level. Funding for the Corps of Engineers would be slightly below the baseline, while increases above the baseline are requested for the Bureau of Reclamation and EPA's hazardous substance response trust fund.

Assistance to Business and Commerce

The major on-budget activities in this area include subsidy payments to the Postal Service and programs of the departments of Agriculture, Commerce, and Energy, the Small Business Administration (SBA), the Government National Mortgage Association (GNMA), and the Export-Import Bank. Outlays for these activities in 1983 were $8.5 billion, representing little change from the $7.6 billion spent in 1975 and slightly below the 1980 level of $8.8 billion. The Administration is proposing to reduce outlays relative to the baseline by approximately $1.4 billion in 1985 and $11.8 billion in total by 1989, with outlays in all years below the estimated 1984 level (see Table V-11). The President's budget represents an outlay reduction of 27 percent below the baseline for the 1985-1989 period, the largest percentage reduction in discretionary spending.

The largest savings are projected for the uranium enrichment program of the Department of Energy. The President is proposing that program obligations be funded entirely with revenues from the sale of enriched uranium, thus requiring no new budget authority beginning in 1985. Because of a weakened market for enriched uranium, CBO estimates that revenues will decline by $500 million in 1985 and and remain at approximately that level through 1989. As a result, the Administration's proposal would effectively reduce operating levels and slow research and development in new technologies, resulting in outlay savings of $0.3 billion in 1985 and a total of $3.8 billion through 1989.

The President is also proposing to reduce the revenue forgone payment to the Postal Service to $400 million per year, beginning in 1985--which would result in outlay savings relative to the baseline of $0.5 million in 1985 and $2.9 billion over the 1985-1989 period. This proposal assumes enactment of legislation proposed last year by the Administration to reduce revenue forgone subsidies for nonprofit mailers. Furthermore, the Adminis-

TABLE V-11. PROPOSED FUNDING CHANGES FOR ASSISTANCE TO BUSINESS AND COMMERCE (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays	8.0	7.4	8.8	9.3	9.7	
Proposed Changes						
Uranium enrichment activities	-0.3	-0.6	-0.9	-1.0	-1.1	-3.8
Postal subsidies	-0.5	-0.6	-0.6	-0.6	-0.7	-2.9
Small business loans	-0.4	-0.5	-0.5	-0.6	-0.7	-2.7
Agriculture and other programs	-0.2	-0.2	-0.4	-0.7	-0.8	-2.4
Total Changes	-1.4	-1.9	-2.4	-2.9	-3.3	-11.8
President's Budget as Estimated by CBO	6.6	5.5	6.5	6.4	6.4	

SOURCE: Congressional Budget Office.

tration is proposing appropriation language that would bar payments in subsequent years to adjust for unanticipated changes in mail volumes and/or rates.

Program cuts are also proposed for SBA, including the elimination of most direct loans and a reduction in guarantee loan levels from $3.3 billion in 1985 to $0.9 billion in 1989. These are estimated to result in outlay savings of $0.2 billion in 1985 and $1.6 billion in total by 1989. In addition, net outlays for disaster assistance total $1.1 billion below the baseline between 1985 and 1989 because baseline levels reflect recent historical experience, while the Administration assumes no major disasters through 1989.

The President would also reduce funding below the baseline for activities of the Agriculture Department. The largest reductions are for the Extension Service and the Animal and Plant Health Inspection Service (APHIS), resulting in savings in each of the programs of approximately $0.4 billion between 1985 and 1989. Parts of this savings reflect proposed increases in user fees collected in connection with APHIS disease and pest control activities.

Other Discretionary Spending

The major other areas of discretionary spending include research and development, federal government operations, and allowances for civilian agency pay raises. In aggregate, outlays in these areas under the President's budget are slightly above the baseline in 1985-1987, and slightly below thereafter.

Research and Development. Spending on civilian research and development (R&D) is estimated to total $18.1 billion in 1984, up from $15.3 billion in 1980. Estimated outlays for these activities in 1984 include $7.0 billion for space and aeronautic research of the National Aeronautics and Space Administration (NASA), $4.4 billion for health research undertaken by the various National Institutes of Health, and $3.4 billion for energy research activities of the Department of Energy. The remaining amounts are primarily for programs in the National Science Foundation and the departments of Agriculture and Education.

The President proposes to increase budget authority for civilian R&D by about $0.5 billion in 1985, and by nearly $3.4 billion above 1984 levels by 1989. These funding levels, however, fall below the baseline by about 2 percent in 1985 and by 3.5 percent over the 1985-1989 period, reflecting a real decline in civilian R&D spending. As a result, outlays would be below the baseline by $0.1 billion in 1985 and by $2.2 billion over the 1985-1989 period (see Table V-12).

Though the President proposes this overall increase in civilian R&D spending, a significant shift occurs among research areas. Spending on most nonspace R&D declines in real terms through 1989. Under the President's budget, outlays would be below the baseline by $0.3 billion in 1986 and by $1.7 billion in 1989. Most of the reductions occur in energy and health research. These reductions primarily result from rates of growth lower than that assumed in the baseline. Proposed budget authority for health research in 1985 is about 2 percent above the 1984 level, and the Administration projects a similar rate of growth for 1986-1989. (The baseline reflects an average annual increase of about 6 percent.) In energy research, major cuts are proposed in nuclear and fossil research programs.

TABLE V-12. PROPOSED FUNDING CHANGES FOR OTHER ON-BUDGET NONDEFENSE DISCRETIONARY SPENDING (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays	44.6	48.1	51.7	55.7	59.8	
Proposed Changes						
Research and development						
Space	*	0.2	0.5	0.6	0.7	2.0
Health	-0.1	-0.2	-0.4	-0.6	-0.9	-2.1
Energy and other	*	-0.1	-0.4	-0.6	-0.8	-2.1
Federal government operations and civilian agency pay raises	0.2	0.4	0.4	*	-0.4	0.6
Total Changes	0.1	0.3	0.1	-0.6	-1.4	-1.5
President's Budget as Estimated by CBO	44.7	48.4	51.8	55.1	58.4	

* Less than $500 million.

SOURCE: Congressional Budget Office.

In contrast, proposed spending on space research by NASA is $2 billion over the baseline between 1985 and 1989. This increase reflects the Administration's commitment of $5.4 billion for design and development of a space station and the commitment to funding a larger space science program. As a result, projected NASA space spending rises from $6.4 billion in 1984 to $8.3 billion in 1989.

Federal Government Operations and Pay. Federal government operations is the only major category of nondefense discretionary spending for which the Administration's budget would maintain baseline spending levels over the 1985-1989 period. (It has also grown faster than any category other than foreign aid from 1980 through 1984.) It includes various basic activities of the federal government, encompassing the conduct of foreign affairs, the Coast Guard, the administration of the Social Security and Medicare programs, law enforcement, judicial, and regulatory activities, the operations of the Legislative Branch, and the Internal Revenue Service. The 1985 budget authority request for these activities is $0.2 billion above the baseline and almost 5 percent above the 1984 level.

Significant increases are requested for State Department operations and the United States Information Agency, resulting in outlays above the baseline by $0.3 billion in 1985 and by $2.3 billion over the 1985-1989 period. Funding for justice programs is generally maintained at 2-3 percent above the baseline level over the five years, including increases for the Judiciary, the Federal Bureau of Investigation, the Drug Enforcement Administration, the Immigration and Naturalization Service, and the federal prison system. The 1985 budget authority request for the Internal Revenue Service is 8 percent above the 1984 level, with outlays projected to be above the baseline by $0.1 billion in 1985 and by $0.6 billion over the 1985-1989 period. Coast Guard operations are maintained at the baseline level, while reductions are proposed in Coast Guard acquisition and construction activities, energy regulatory and administrative activities, and the juvenile justice grant program. The budget assumes pay raises for civilian agency employees of 3.5 percent in January 1985, and 5-6 percent per year thereafter.

OFFSETTING RECEIPTS

This category consists of various federal government receipts that are treated as deductions from outlays rather than as revenues. It includes proprietary receipts from the public, largely for lease, sale, or royalty payments for timber, power, or minerals. It also encompasses the receipts from federal agencies' payments (as an employer) for employee retirement and health benefits. Finally, health insurance premiums paid by Supplemental Medical Insurance recipients are treated as offsetting receipts.

The President's budget proposals in offsetting receipts are dominated by the proposed change in the SMI premium. Under current law, SMI premiums are set at 25 percent of program costs through 1985, and are increased by the growth in the CPI thereafter. The President's budget proposes increasing the premiums by 1.67 percent of program costs until January 1, 1990, when premiums would equal 35 percent of program costs.

Under current law, CBO estimates monthly premiums of $20.40 by 1989. Under the Administration's proposal, monthly premiums would increase to $35.60 in 1989, a 75 percent increase. This proposal would add $11 billion to offsetting receipts from 1985 to 1989.

Other Administration proposals for offsetting receipts would have the Postal Service make additional payments to the Civil Service Retirement trust fund and would impose navigation user fees in anticipation of legislation to recover capital and operating expenses of deep draft and inland waterway projects.

OFF-BUDGET SPENDING

The spending of certain federal entities has, by law, been excluded from the unified budget total. These include oil purchases for the Strategic Petroleum Reserve and operations of the Postal Service. The Federal Financing Bank (FFB) accounts for most off-budget outlays through its purchases of direct or guaranteed loans made under other government programs. Purchases of loans from other, on-budget federal agencies reduce on-budget outlays and transfer off-budget most of the impact of agencies' lending activities. Purchases of guaranteed loans convert such guarantees into direct federal loans, with outlays appearing off-budget.

Under the Administration's proposals, off-budget outlays are projected to decline from $15 billion in 1984 to $6 billion in 1989, a reduction of $28 billion below the baseline over the 1985-1989 period (see Table V-13). Almost $19 billion of that reduction is the result of proposed changes in the financing of foreign military assistance, which were discussed earlier in this chapter. The remainder is chiefly attributable to reductions in credit activity of the Rural Electrification Administration (REA) and the Farmers Home Administration (FmHA), offset in part by additional expenditures for public housing bonds.

For REA, the President's budget includes a substantial reduction in both direct loans and loan guarantees. Commitments for direct loans would be cut from $1.1 billion in 1984 to $575 million in each of the years 1985 through 1989. Loan guarantee commitments would be cut from $3.4 billion in 1984 to $1.3 billion a year, beginning in 1985. In addition, the President is proposing that higher interest rates be charged for REA direct loans. REA credit activity is off-budget. In addition, a portion of REA's direct loans is sold to the FFB, and REA's guaranteed loans become direct loans made by the FFB. As a result, the Administration's proposals would reduce off-budget outlays, relative to the baseline, by $0.8 billion in 1986 and by $6.6 billion over the 1985-1989 period.

TABLE V-13. PROPOSED FUNDING CHANGES FOR OFF-BUDGET SPENDING (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Changes
CBO Baseline Outlays	14.1	13.9	15.2	16.0	14.7	
Proposed Changes						
Foreign military sales credit	-1.2	-3.3	-4.3	-4.9	-5.1	-18.8
Rural Electrification Administration	*	-0.8	-1.5	-2.0	-2.3	-6.6
Farmers Home Administration	-0.3	-1.5	-1.7	-1.9	-2.0	-7.4
Low-rent public housing	1.2	1.2	1.2	1.2	1.2	6.0
Other	-0.2	*	-0.7	-0.2	-0.3	-1.5
Total Changes	-0.5	-4.4	-7.0	-7.8	-8.5	-28.2
President's Budget as Estimated by CBO	13.6	9.5	8.2	8.3	6.2	

* Less than $500 million.

SOURCE: Congressional Budget Office.

A large portion of the financing needed by the FmHA's agricultural credit, rural development, and rural housing direct loan programs comes from the sale of loan assets to the FFB. To the extent these FFB sales occur, program costs are reflected off-budget, rather than in the unified budget. Under the President's budget proposals, CBO estimates a 1985 loan level of about $7.5 billion, $1.3 billion less than the level assumed for the CBO baseline and $1.1 billion below the 1984 level. (The 1985 total includes

$2.3 billion for emergency disaster loans, a CBO reestimate. These loans are not subject to limitation.) For the five years 1985 through 1989, the Administration budget includes loan levels about $9.8 billion less than assumed in the CBO baseline, resulting in a reduction in off-budget outlays for the five-year period of an estimated $7.4 billion. Most of this reduction would occur in FmHA's rural housing programs.

These off-budget savings would be offset, in part, by increased outlays of $1.2 billion per year for the sale of public housing bonds to the FFB. These sales would result in off-budget outlays totaling an estimated $6 billion over the 1985-1989 period.

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APPENDIXES

APPENDIX A. CBO OUTLAY REESTIMATES

As part of its analysis of the Administration's budget, CBO has reestimated the Administration's spending program to reflect CBO baseline economic assumptions and technical estimating methods. The effect of these reestimates on outlays is summarized in Table A-1 and explained in this appendix. Most of the CBO reestimates result from the use of different economic assumptions--primarily higher interest rates. These different economic assumptions increase estimated outlays by an amount growing from $2 billion in 1984 to $87 billion by 1989. Technical estimating differences reduce CBO's 1984 outlay estimate by $5 billion but increase estimated outlays thereafter. By 1989 technical estimating differences reach $16 billion, of which $10 billion is in the national defense function.

TABLE A-1. CBO'S REESTIMATES OF THE ADMINISTRATION'S SPENDING PROPOSALS (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
President's Budget	854	925	992	1,068	1,130	1,184
Preliminary CBO Reestimates						
Different economic assumptions	2	8	17	32	59	87
Technical reestimates	-5	*	9	11	15	16
Subtotal	-3	8	26	43	74	103
President's Budget as Estimated by CBO	851	933	1,018	1,011	1,204	1,287

* Less than $500 million.

SOURCE: Congressional Budget Office.

DIFFERENCES IN ECONOMIC ASSUMPTIONS

The major difference between CBO and Administration economic assumptions, as discussed in Chapter II, regards interest rates. Budget estimates are becoming increasingly sensitive to interest rates as past and projected deficits add to the amount of federal debt that must be financed. CBO assumes that the three-month Treasury bill rate will average 8.9 percent in calendar year 1984 and will decline to 7.8 percent in 1989. In contrast, the Administration assumes that the bill rate will drop to 5.0 percent by 1989. Differences in assumed longer term rates are even greater--CBO assumes a 10.2 percent three- to five-year note rate for 1989, while the Administration assumes 5.5 percent. CBO estimates that

TABLE A-2. CBO OUTLAY RESTIMATES DUE TO DIFFERENT ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
Interest Costs						
Due to different interest rates	1	7	14	24	41	58
Due to different deficits	*	1	2	5	9	17
Subtotal	1	7	16	29	51	75
Other Interest-Sensitive Programs	*	*	*	1	1	1
Social Security and Other Indexed Benefits	*	1	1	3	4	6
Medicare and Medicaid	*	1	1	1	2	3
Unemployment Compensation, Food Stamps, and AFDC	1	-1	-1	-1	1	3
Total	2	8	17	32	59	87

* Less than $500 million.

SOURCE: Congressional Budget Office.

these higher interest rates will increase interest costs by $1 billion in 1984, $7 billion in 1985, and $58 billion by 1989. Economic reestimates of outlays and revenues further increase interest costs by increasing the amount of debt to be financed. In total, differences in interest outlays account for $7 billion out of $8 billion in economic reestimates in 1985 and $75 billion out of $87 billion by 1989 (see Table A-2). Higher interest rates also increase outlays for certain other federal programs, notably guaranteed student loans.

The inflation rates projected by CBO exceed the Administration's by increasing amounts in successive years. As a result, CBO estimates higher outlays for Social Security, federal employee retirement, and other benefits indexed to the Consumer Price Index. Differences in indexed programs are $1 billion or less in 1984, 1985, and 1986 but grow to $6 billion by 1989. Medicare and Medicaid outlays are also higher in CBO's estimates because higher inflation pushes up the cost of providing services to eligible families and individuals.

CBO's projected civilian unemployment rate is lower than that of the Administration in 1985-1987, but the Administration's rate drops below CBO's in the final two years of the budget estimates. CBO therefore estimates lower outlays for unemployment compensation and other unemployment-sensitive programs in the 1985-1987 period but higher outlays in 1988 and 1989.

TECHNICAL ESTIMATING DIFFERENCES

Table A-3 lists the major technical estimating differences between CBO and the Administration. The next section of this appendix discusses the differences in defense estimates. The concluding section covers the remainder of the budget.

National Defense

CBO estimates that defense outlays under the Administration's request will be $25 billion higher over the 1984-1989 period than the Administration estimates. The reason for this large estimating difference--most of which is in defense procurement--is not clear. In making its estimate CBO assumes the same total program as the Administration assumes in all years and the same program composition in 1984 and 1985. Because the Administration does not detail its program mix beyond 1985, CBO assumes a mix within each appropriation category consistent with the mixes in the

TABLE A-3. CBO OUTLAY RESTIMATES DUE TO TECHNICAL ESTIMATING DIFFERENCES (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
National Defense						
Procurement	*	2	3	3	6	8
Operations	-1	1	2	1	1	2
Other	-1	-1	*	*	*	1
Subtotal	-3	1	5	4	8	10
International Affairs	-1	-2	-2	-1	*	*
Mineral and Timber Receipts	*	*	1	1	1	1
Farm Price Supports	*	*	3	3	2	2
Medicare	-1	-2	-2	-2	-1	*
Social Security	*	-1	-3	-4	-4	-4
Net Interest						
Estimating Differences	*	1	2	2	2	-1
Different Deficits	*	*	1	2	4	7
Subtotal	-1	1	3	4	6	6
OCS Receipts	2	2	4	5	4	3
Other, Net	-2	*	*	1	*	-2
Total	-5	*	9	11	15	16

* Less than $500 million.

SOURCE: Congressional Budget Office.

earlier years. CBO and the Administration both expect that some appropriations will never be spent; CBO assumes that about one percent of defense budget authority will not translate into outlays. Questions of program mix and appropriation lapses, however, cannot explain much of the estimating differences.

Procurement. CBO's outlay estimates for procurement are shown in Table A-4; the budget authority is the Administration's request and total outlays are decomposed into the amounts due to each year's appropriations. The implicit outlay rates shown in the bottom panel of the table indicate that the program mix contained in the estimates tends toward slower spending programs, but is basically stable.

The Administration has not provided a similar decomposition of its procurement estimates, but when CBO attempted to reconstruct the Administration estimate using published DoD outlay rates for 1984 and 1985, it was unable to do so. In fact, using published Administration outlay rates, CBO computed outlays that exceeded Administration estimates by $3.0 billion in 1986, $3.9 billion in 1987, $7.5 billion in 1988, and $10.6 billion in 1989. This inconsistency in Administration estimates could explain much of the difference with CBO for procurement outlays.

Operations. As defined here, operations combines the operation and maintenance (O&M) accounts and the revolving funds. CBO groups these categories because an outlay change in one is often balanced by an offsetting change in the other; the O&M accounts are the main customers of the revolving funds and receipts in the latter are often disbursements from the former. This year, however, the Administration is requesting $3-4 billion per year between 1986 and 1989 to enhance revolving fund inventories--an action that would increase total budget outlays because there would be no offsetting receipt from the O&M accounts.

The difficult estimating question is what outlay rate to use for the revolving funds' budget authority. CBO assumes that the first year spending will be about 76 percent of the appropriation, with the balance of spending in the second and third years. The Administration apparently assumes that all 1984 and 1985 budget authority will be spent in the first year.

Assuming a 100 percent outlay rate for the revolving funds and DoD's published outlay rates for the O&M accounts, a discrepancy emerges between Administration outlay rates and Administration outlay estimates. Like procurement, the outlay estimates appear too low. In operations the underestimate averages $1 billion per year and explains 75 percent of the estimating difference between CBO and the Administration. (Relaxing the

TABLE A-4. CBO OUTLAY ESTIMATES FOR DEFENSE PROCUREMENT BASED ON THE PRESIDENT'S FEBRUARY BUDGET AUTHORITY REQUEST (By fiscal year)

	1984	1985	1986	1987	1988	1989
			Billions of Dollars			
Budget Authority (BA)	85.2	107.9	126.0	137.0	147.1	161.5
Outlays from						
1983 and prior BA	52.0	33.5	16.1	8.6	4.8	1.3
1984 BA	12.1	30.6	22.9	9.3	5.6	3.2
1985 BA		15.6	38.7	28.8	11.6	7.0
1986 BA			17.0	44.8	33.8	13.9
1987 BA				18.2	48.1	36.6
1988 BA					19.2	51.1
1989 BA						21.4
Total Outlays a/	64.1	79.6	94.7	109.7	123.1	134.4
			Percent			
Implicit Outlay Rates from New BA for						
1984	14.2	35.9	26.9	10.9	6.6	3.8
1985		14.5	35.9	26.8	10.8	6.5
1986			13.5	35.6	26.8	11.0
1987				13.3	35.1	26.7
1988					13.1	34.7
1989						13.3

SOURCE: Compiled by CBO from data supplied by the Department of Defense, and the CBO.

TABLE A-5. CBO TECHNICAL REESTIMATES FOR OTHER DEFENSE PROGRAMS (By fiscal year, in millions of dollars)

	1984	1985	1986	1987	1988	1989
Military Personnel	41	-243	-222	-265	-281	-285
RDT&E	-1,157	-753	130	240	403	608
Military Construction	-68	-216	55	141	371	570
Family Housing	-237	-215	-244	-244	-244	-244
Other	-26	-50	-1	--	--	--
Total	-1,448	-1,477	-282	-128	249	649

SOURCE: Compiled by CBO from data supplied by the Department of Defense, and the CBO.

100 percent outlay rate assumption to the CBO rates reduces the discrepancy to $0.9 billion per year.)

All Other. For the remaining categories of defense spending, CBO estimates lower outlays in 1984 to 1987 and higher outlays in 1988 and 1989, as shown in Table A-5. CBO would estimate lower net outlays throughout the six-year period were it not for inconsistencies between Administration outlay rates and outlay estimates similar to those discussed above for procurement and operations. Between 1986 and 1989, CBO's reconstruction of the Administration's estimate points to outlays averaging $550 million per year more than Administration estimates or $450 per year more than CBO estimates.

Nondefense Spending

Technical estimating differences between CBO and the Administration are small for nondefense spending in the aggregate, although there are a number of offsetting pluses and minuses. CBO projects lower outlays for international affairs, primarily the Export-Import Bank and foreign military sales financing. CBO expects smaller increases in Export-Import Bank direct loan obligations because of relatively slow growth in exports to the less developed countries, the largest customers for Export-Import Bank financing. CBO is also estimating slower disbursements for foreign military

sales direct loans, consistent with the experience of the off-budget foreign military sales loan program.

CBO estimates that receipts from onshore mineral leases will be less than the Administration projects because of smaller oil and coal production and lower energy prices. Projected timber receipts are also lower because of fewer housing starts and lower demand for lumber.

CBO has substantially higher farm price support outlays than the Administration in 1986 and later years, mostly because of lower wheat and dairy prices. For wheat, CBO assumes higher yields per acre than the Administration and lower participation in acreage reduction programs. For dairy, CBO projects a less rapid decline in herds and a slower growth in consumption.

Medicare and Social Security outlays are lower in CBO's projections than in the Administration's for technical reasons. CBO has lowered its estimate of Hospital Insurance outlays for fiscal year 1984 to reflect recent experience in the program; CBO assumes a more rapid growth rate in later years, however, so that the technical differences are less than $500 million by 1989. The technical differences in Social Security result from generally lower CBO projections of the beneficiary population.

The technical differences in net interest outlays result primarily from the effect of other technical differences on deficits. In addition, however, there are some technical estimating differences in the net interest function itself. Based on traditional Treasury debt management practices, CBO estimates that 33 percent of each year's financing will be accomplished through Treasury bill sales. In contrast, the Office of Management and Budget generally assumes that 35 to 36 percent of borrowing will be accomplished with bills, which generally have lower interest rates than longer term instruments. OMB also assumes net purchases of savings bonds in all periods, even though the introduction of the new market-based savings bonds has not stanched the flow of net redemptions. Consistent with its estimates of Outer Continental Shelf receipts (discussed in the next paragraph), CBO also assumes that interest receipts from OCS esrow releases will be less than the Administration projects in 1985-1987 but greater in 1989. As a result, the total estimating differences in net interest become negative in 1989.

The largest technical estimating difference between CBO and the Administration, aside from national defense, is in receipts from oil and gas leasing and production on Outer Continental Shelf tracts. The differences are smallest in 1984 and 1985 but grow thereafter. For fiscal years 1986 through 1989, CBO assumes that bonus receipts will remain at about the

1985 level, while the Administration assumes that bonuses will increase by about 10 percent per year. Because of lower energy price and production levels, CBO also has lower royalty estimates each year. Finally, CBO estimates that litigation over funds now in escrow will not be resolved as early as the Administration assumes. This will result in smaller escrow releases through 1988 and greater releases in 1989.

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